

# **THE POSSIBLE IMPACT OF THE PROPOSED SOUTH AFRICAN REIT STRUCTURE ON THE LISTED PROPERTY SECTOR**

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## **DECLARATION**

I declare this research report is my own unaided work. It is being submitted for the Degree of Master of Science in Property Development and Management (Building) at the University of the Witwatersrand, Johannesburg. It has not been submitted before for any degree or examination in any University.

\_\_\_\_\_.

(Signature of Candidate)

\_\_\_\_\_ day of \_\_\_\_\_ year \_\_\_\_\_.

## **ABSTRACT**

A Real Estate Investment Trust is simply a body that utilises collective funds to manage and purchase income producing properties. The terminology is widely recognised internationally, although in South Africa a structure exists which is not too dissimilar to the Real Estate Investment Trust, the listed property sector in South Africa is undergoing a huge shift as a result of the more distinguished Real Estate Investment Trust structure being proposed by the National Treasury. This report focuses on establishing whether the proposed structure is expected to have an impact on the listed property sector in South Africa. The hypothesis is tested through the use of literature and research pieces stemming from countries where the structure is currently in existence. The proposed South African Real Estate Investment Trust structure is studied critically to determine the key issues that will impact on performance of a listed fund, and is also compared to a selection of existing structures around the world. The key findings were conclusive in that the Real Estate Investment Trust is expected to have a positive impact on the listed property sector.

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# **1 INTRODUCTION**

## **1.1 Background**

There has currently been much talk about the proposed movement for the incorporation of the South African listed property market into the more internationally reputable REITs structure. REIT is an acronym for the Real Estate Property Investment Trust. Currently in SA two types of listed property investment vehicles exist. The first type is known as Property Units Trust (PUT). The second type is known as Property Loan Stocks (PLS), which are simply listed property funds.

There are various differences between the two, mainly due to their differing financial forms; with the one being a Trust (the PUT) and the other a Company (the PLS). At present the two are not on a level playing field, both in terms of tax and statutory regulations. The proposed call for REITs is being strongly welcomed by the listed property market. The move is intended to make the SA listed property sector more competitive worldwide, to increase foreign investment in the SA listed property sector, as well as to level the playing field for the two investment vehicles in addition to providing better protection for investors.

REITs have existed for many years around the world. With SA looking to implement REITs now, various ideas, concepts and regulations will be imitated in the South African REIT industry. 72% of the global real estate market is currently held in a REIT-type structure. To date the following countries have a REIT structure: Australia, Belgium, Bulgaria, Canada, France, Hong Kong, Israel, Japan, Korea, Malaysia, Netherlands, New Zealand, Singapore, Taiwan, Thailand, Turkey, UK, and the USA.

The following countries are in the process of developing a REIT structure: Brazil, Costa Rica, Finland, Germany, India, Italy, Mexico, Nigeria, Pakistan, Philippines and South Africa.

### **1.2 Problem Statement and Hypothesis**

The implementation of REITs is expected to have an impact on the listed property sector in South Africa. The general expectation is that the change in structure would have a positive impact on the listed property sector. The trends and observations in countries with existing structures are analysed in this dissertation, and a predictive look is taken at the possible impact of REITs upon implementation in South Africa.

### **1.3 Need for the study**

With many countries already containing a REIT structure, and others looking set to follow suit, REITs in the next couple of years could prove to be a worldwide trend in property markets. Understanding the existing structures and the proposed structure by, for example, the South African Treasury, would be useful to those formulating policies. It will also help when gauging what the impact may be on the listed sector

### **1.4 Research Objectives**

- Looking at key issues in a REIT structure to identify those which may affect performance and structure.
- Identifying key issues, and analysing why and how these can impact a REIT.
- Comparing the South African market to international structures.
- A critical analysis of the REITs structure.

## **1.5 Research Methodology**

In order to achieve the required objectives, a qualitative research through questionnaires and interviews was conducted. An attempt to get the industry's view on the proposed structure of REITs in South Africa is the aim of the questionnaires and interviews. "Rating" the South African proposal against existing structures worldwide is a theme of the research.

A sample of 21 respondents was used, which predominantly consisted of asset managers of listed property funds.

The data was analysed graphically to show either common industry thinking or differing opinions.

## **1.6 Outline of the study**

The structure below is followed in presenting this study:

Chapter 1 (Introduction) provides an overview and purpose of this research. It outlines the main objectives of the research and states the aspects the study is attempting to clarify.

Chapter 2 (Literature Review) looks at the existing REIT structures around the world.

Chapter 3 (Methodology) explains how the study was conducted. Methods used and data sources are introduced.

Chapter 4 (Data Presentation and Analysis) presents findings using various illustrative means such as graphs and tables. Further, the data is analysed through qualitative and quantitative methods.

Chapter 5 (Conclusion) documents conclusions based on findings and analyses.

## 2 LITERATURE REVIEW

This chapter discusses the literature on the topic in three parts.

The first part looks at the REIT structures and key issues arising out of the selected country's structures.

The second part examines the key issues relating to international REIT structures and also looks at the impact on listed property of countries adopting the structure.

The third part compares and discusses the proposed South African structure versus the structures of the selected countries.

The literature covers papers and articles surrounding the selected existing REIT structures around the world, with particular reference to the impact seen upon the adoption of the REIT structure. The research is limited to the following countries; United States of America, Canada, Netherlands, United Kingdom, Australia, Japan and Singapore. A South American country could not be chosen as there is no REIT structure in that continent. Although Brazil has what they call a REIT, NAREIT (the National Association of Real Estate Investment Trusts) argues that their REIT is mainly used as a special-purpose entity only; existing for owning and operating independent property investments, and it is mostly funded with private capital. According to *investorwords.com*, a "Real Estate Investment Trust is a corporation or trust that uses the pooled capital of many investors to purchase and manage income property (equity REIT) and/or mortgage loans (mortgage REIT). REITs are traded on major exchanges just like stocks." For the reason that REITs are traded on a listed exchange, Brazil has to be excluded from the analysis. This chapter focuses on the analysis of the structure in the abovementioned countries under the following

headings (in no particular order): Corporate Governance, Tax Structure, Gearing and Investment Restrictions.

The countries mentioned above were selected for the following reasons:

- United States of America – A REIT structure has existed in the United States of America since the 1960's. They are the leaders in terms of REIT thinking and much can be learnt from them, as they have tried and tested many structures to reach the point at which they find themselves today.
- Australia – the second country after the USA to introduce the REIT structure into their listed property system.
- Canada was one of the first countries to implement REITs and it is interesting to see the degree to which their structure mimics the Americans, and how it differs.
- United Kingdom – This is a major powerhouse in the world economy, however they only introduced REITs into their listed property system in early 2007.

One can see how recent structures differ to the older structures in USA and Australia. Much can be learnt from the problems that have been encountered. Despite some years since implementation, these countries are still struggling with the full implementation of REITs.

- Netherlands – They were the first European country to implement the REIT structure.
- Japan & Singapore – These were selected to get a more global view of the existing structures around the world. Many countries in Asia have the REIT

structure, but Japan and Singapore have been selected to represent the Asian market.

Adding further to the earlier definition of a REIT, the property loan stock association of South Africa defines a REIT as 'An entity owning and operating income producing property'. Currently in South Africa two listed property investment vehicles exist, namely a Property Unit Trust (PUT) and a Property Loan Stock (PLS). The fundamental differences according to the Association of Property Unit Trusts and the Property Loan Stock Association of SA between the two at present are as follows:

- A PLS pays capital gains tax on profits made from sale of assets, while a PUT doesn't pay capital gains tax provided these profits are distributed to shareholders.
- PUT's are not permitted to invest in other listed companies while PLS's can.
- There are different gearing limits for the two (limited to the amount stated in the companies articles for a PLS and 30% of the value of underlying assets for a PUT).
- They are governed by two different acts (the Companies Act for a PLS; and the Collective Investment Schemes in Property Act for a PUT).

The qualifying criteria, as stated by the Association of Property Loan Stocks, are listed below:

- The REIT must be an entity that is taxable as a corporation
- It must be managed by trustees or a board of directors.
- The shares must be fully transferable.
- The REIT must have a minimum of 100 shareholders.

- The REIT must have no more than 50% of its shares held by five or fewer individuals for at least half the taxable year.
- It must invest at least 75% of its total assets in property.
- The REIT must derive at least 75% of its income from property rentals received.
- The REIT must have no more than 20% of its assets consisting in Taxable REIT subsidiaries.
- Lastly, the REIT must distribute at least 90% of its taxable income to shareholders.

The uniformity that will be created by converting PLS's and PUT's to REITs is that they will both now be able to invest in other listed property companies (although there is a limit placed on this, as stated earlier), they have a uniform gearing limits, and taxes charged will be somewhat comparable. Many property experts believe that converting to REITs will make the South African listed property sector more understandable globally, and thus facilitate foreign investment as opposed to the perplexing PLS's and PUT's. On a local level it will also create a level playing field from tax and governance points of view.

## **2.1 PART 1**

This looks at the key issues that arise when examining the REIT structures from the selected countries, in addition to comparing the structures with one another.



### **2.1.1 The United States of America. (US)**

Established in 1960, the US REIT market is the largest in the world. Currently there are in excess of 200 listed REITs existing in the US. The principal reason for the implementation of REITs was a simple one. It was motivated by Congress's need to stimulate investment in larger properties previously only available to larger corporations with considerable resources. In other words this allowed smaller investors to pool funds together and invest in property. REITs in the US have been growing considerably since its inception. US REITs got a huge helping hand from the inclusion of REITs into the Standard and Poor list of indexes. Since this inclusion (according to an article on [www.reita.org](http://www.reita.org)) (REITA - an acronym for Real Estate Investment Trust Association), the value of REITs nearly doubled. Consistent outperformance by US REITs of major benchmarks has also sparked the growth of US REITs. In the US another type of REIT exists. This is known as the umbrella partnership REIT, more commonly known as an UPREIT. The UPREIT does not directly own properties, but instead owns shares of the underlying properties in a partnership, either directly or indirectly. According to Geltner & Miller (2001), the reason for the existence of an UPREIT is that it allows property owners to sell their properties to a REIT without incurring a taxable event. This will be discussed in further detail when we address Tax issues within a REIT structure.

In the US, there is no gearing limit imposed on REITs. In the US it is believed that this allows for flexibility and enables market forces to determine the gearing limit.

Pre 1999, US REITs were required to issue 95% of taxable income in the form of dividends. In 1999 a REIT Modernization Act was established which reduced this to 90%. Moreover, a US REIT is required to invest a minimum of 75% in property.

US REITs pre 1986 were smaller and couldn't provide even the basic of maintenance (known as customary services) to the properties they owned. Due to their size they were almost forced to outsource the property management function. In 1986 the US legislation allowed REITs to provide basic services to their tenants. Following this change in legislation most REITs converted to internal management. Another interesting observation with US REITs is that if a REIT produces less than 1% of its income through services such as cleaning, maintenance, lighting, heating, lease negotiations, tenant sourcing, and so forth, such income will be treated as income from rents. However should this exceed 1% then a REIT must use an independent third party or a fully taxable REIT subsidiary (TRS). However such income is not permitted to exceed 5% otherwise a REIT faces loss of status. Another stipulation in US law is that no more than 20% of a REIT's assets can lie in a TRS. In essence today there is no legislation in the US that prevents external management, but the vast majority (according to NAREIT 90% of their members) have internally managed REITs. Common types of agency costs found according to Geltner & Miller (2005) are listed below.

- Transaction bias in the case of umbrella partnerships (UPREITs). The problem with this structure is that it permits the REIT to purchase properties from taxable individuals, while allowing such individuals to defer realizing a capital gain taxable event.
- Real Estate interests outside the REIT. The situation is believed to exist where management have interests outside the REIT. A conflict of interest arises

where the time spent by managers is to be shared with the management of properties outside the REIT.

- The potential for self dealing. This occurs where the REIT perhaps hires a management company that is affiliated to the sponsoring shareholders and “less than arms-length transactions” take place.

### **2.1.2 Australia**

Australia initiated their equivalent of REITs, the Listed Property Trust, in 1971. In Australia the Listed Property Trust is known to have one of the least restrictive structures as compared to other global REIT structures. To date, according to the REITA, funds under management in Listed Property Trusts are A\$275bn, and they also believe that before the end of 2010 this value will be closer to A\$500bn. The reason for the emergence of listed property trusts are listed below:

- lower volatility, with a steady income stream and reasonable capital growth potential
- investing in a diversified portfolio of quality properties managed by professional managers
- lower entry and exit costs compared to direct property investment and a cost effective method to gain exposure to the property sector(s)
- taxation advantages via tax concessions passed-through and tax-deferred dividend from property rental.

The Australian listed property trust is gaining worldwide growth for two reasons.

The first is that it is the most transparent market in the world as there are stringent reporting regulations to ensure that information is made available to the public.

The second reason is that Australia is the most securitised market in this asset class, ranging between 40 and 60% as compared to approximately 6% in the US.

Securitisation is simply the pooling of mortgages. Essentially, capital flows from bond market investors to property investors. The principal and interest returns are then ‘thrown’ into the pool which is re-packaged by investment banks and bond rating agencies into ‘tranches’ or shares defining what the bond market investors have bought (Keng and Newell, 2005).

The Australians are currently considering changing the name to the A-REIT. This will be regarded as more conventional internationally, and is also believed to assist the market in attracting foreign investment.

In Australia there is also no gearing limit. The early REIT structures seem to follow the unlimited gearing route. In Australia a REIT is required to issue 100% of taxable income as dividends.

There is no stipulation as to how the management of such an entity should be structured within a REIT (LPT) i.e. it can be internal or external. Traditionally Australian REITs were managed externally. However, featuring more prominently today is what they term a “stapled securities” structure. The stapled securities structure essentially allows the LPT to operate as a trust and a management company simultaneously. The stapled structure is formed by “combining” or “stapling” units in the trust to shares in the Management Company. Such LPT’s effectively adopt the internally managed structure. The stapled structure prevents payments of fees to a third party. Investors in a stapled structure LPT effectively own two securities (shares

and units) linked together by the LPT and received two sources of income namely those generated by the property portfolio and business decisions undertaken by the management company. The two securities cannot however be traded independently of each other.

According to REITa (Real Estate Investment Trust Association) one of the appealing features of choosing an LPT as an investment is that it comes with a professional manager. This is not just one person, but a team that manages the day to day running of the properties, sourcing of tenants and ensuring rents are in line with expectations and are collected on time. The manager also implements the investment strategy by choosing investments, and where appropriate, selling or refurbishing properties. The manager earns a fee for providing these services on behalf of their investors.

In Australia a REIT is required to invest a minimum of 50% in property. Another stipulation for Australian REITs is that at least 50% of their income must come from rents.

### **2.1.3 Canada**

We will briefly look at the Real Estate cycle in Canada which led to the adoption of the REIT structure in 1993, as per Delloite's Edition 8 of the REIT Guide (2004).

In the 1970's, as observed by Delloite Consulting, the Canadian real estate market boomed mainly due to an incursion of funds from Europe, caused by Russian political threats in Europe, and a decrease in investment risk in areas such as Canada. The

demand for development increased, and in order to access funds to cater for the development demand, joint ventures and syndicates were used to raise capital.

The 1980's brought about the climax of syndication and increased capital growth of properties. As a result of growing investor confidence, gearing / leverage increased to finance development activities. This added borrowing brought about increased risks, and as a result of syndications failing to meet their payment obligations, the banks had to "call" on their loans. This resulted in investors incurring large losses which also meant that banks and lending institutions were the eventual holders of real estate.

The 1990's saw investors looking to re-evaluate real estate as an investment class. They turned to earlier fundamentals of real estate investing, focusing on cash flows rather than looking at real estate as speculative investments. Real Estate was unable to provide the returns investors sought, and as a result of the "technology boom", real estate saw large outflows of investments. Open ended funds (short term investments) collapsed as a result of failing syndications. This led to the emergence of closed end funds (longer term investments). Closed-end mutual fund trusts are the Canadian equivalent to the U.S. REITs and, in many respects, have been made to function like a U.S. REIT. Since the first REITs listed in 1993, there are eighteen listed REITs in Canada.

Canada seems to follow the US pattern by having no gearing limit.

The Canadians require a REIT to issue 85% of taxable income as dividends.

Canadian law insists that management must be internal.

Canadian REITs are required to invest a minimum of 80% in property.

#### **2.1.4 The United Kingdom**

The United Kingdom only implemented REITs on the 2<sup>nd</sup> of January 2007. There had been widespread talk about their implementation for many years. The move was however criticised by many, the underlying argument being that many mechanisms of property ownership existed and there was doubt as to whether another vehicle was required. Careful inspection of property ownership reveals the true reason for the implementation of REITs. High taxation, requiring the need for larger capital outlays and inflexibility, caused investors in U.K. property to look elsewhere for more efficient investments, sparking a growth in offshore investment. The implementation of REITs in the U.K. market is designed to create a better organised and efficient form of property ownership, ensuring also that investors pay an appropriate level of tax. In addition they hope to attract property investment as an asset class to a wider range of investors. The proposed implementation created huge interest from US REITs, and many also predicted that REITs would become a significant part of personal pension and retirement plans.

In the U.K., the restriction on gearing is 1.25 times the interest cover test, which means that earnings before interest and taxes divided by the interest expenses for that year is not permitted to fall below 1.25. This equates to a REIT being able to borrow approximately 65% of the total value of their portfolio.

U.K. REITs are required to pay out 95% of taxable income to shareholders.

U.K. REITs have the option of either internal or external management.

Their REIT is required to invest a minimum of 75% in property.

### **2.1.5 Netherlands**

The Dutch implemented REITs in 1969, under the Dutch Corporate Income Tax Act of 1969. They were the first European country to do so. In spite of the length of time that Dutch REITs have been operational, the structure was reviewed a few years ago. The Dutch REIT structure is said to be too restrictive, and is losing investment to other countries such as Luxembourg and Belgium.

- Their gearing limit is 60% of the REITs total assets. The Dutch seem to have been the first of the REIT implementers to limit gearing.
- Dutch REITs are required to issue 100% of fiscal income as dividends. This illustrates the restrictive structure of their REITs.
- The Dutch law also prohibits REITs from being externally managed.
- Dutch REITs are only allowed to invest in property.

### **2.1.6 Japan**

The Japanese adopted a REIT structure in December 2001. There are currently 32 listed REITs in Japan. The J-REIT, as it known today, was established by government to restructure the sluggish economy and in turn promote property investments in Japan.

In Japan again we see no limit to the amount of gearing. Internationally the norm among many REIT structures seems to be unlimited gearing



- Japanese REITs are required to issue 90% of fiscal income as dividends
- The management structure of their REITs must be external.
- Their law requires REITs to invest a minimum of 75% in property

Scott Crowe, director and global real estate strategist with UBS Asset Management, said, (quoted in an article by Courtney Darby of NAREIT in 2005) that Japanese land prices had been declining over the last 15 years due to a sluggish economy, and the inception of REITs has been highly advantageous to Japanese real estate making it more liquid. This enabled investment funds to flow into real estate, which stopped asset deflation. NAREIT noticed that the dividend yield for real estate securities was less than 1 percent prior to the adoption of the J-REIT structure. Today, the Japanese REIT dividend yield is 3.2 percent.

According to a publication by Price Waterhouse Coopers (Overview of Japanese REITs, 2006) REITs were gaining acceptance by investors in Japan and internationally in a very short time span mainly due to:

- the credibility of their sponsors
- higher yields when compared with bond interests
- credibility due to strict regulation
- return stability, and
- the lure of an opportunity to invest in diversified Japanese real estate market

However discussion on the success of Japanese REITs led to a consensus that a lack of high-yield, fixed-income alternatives has contributed to J-REIT success along with general growth of the Japanese economy. Further, that interest by foreign investors in

enhancing the diversification of their real estate allocations has also been a major driver toward J-REIT success.

### **2.1.7 Singapore**

The first Singapore REIT was listed in 2002, and today there are six listed REITs. REITs were implemented as they provided an indirect vehicle for developers with large portfolios of low-yield income-producing commercial properties to split off from the asset holdings, and unlock book values of the assets (Foo, 2005).

In Singapore gearing is capped at a limit of 35%. It is evident that Singapore has the lowest borrowing limit from the countries selected for comparison.

Their management structure follows the Japanese example, and must be external.

### 2.1.8. Comparisons

**Table 2.1: Differences between the REIT structures of the selected countries.**

COUNTRY	MANAGEMENT STRUCTURE	INVESTMENT IN REAL ESTATE	FOREIGN INVESTMENT	DEVELOPMENT	GEARING LIMIT	PAYOUT	TRADING REQ
US	EITHER	MIN 75%	Y	ALLOWED	UNLIMITED	90%	LISTED / UNLISTED
UK	EITHER	MIN 75%	Y	ALLOWED		95%	LISTED
CANADA	INTERNAL	MIN 80%	Y	ALLOWED	UNLIMITED	85%	LISTED
AUSTRALIA	EXT OR INT (STAPLED TRUST)	MIN 50%	Y	ALLOWED	UNLIMITED	100%	LISTED / UNLISTED
HOLLAND	INTERNAL	100%	Y	MINIMAL	60%	100%	LISTED / UNLISTED
SINGAPORE	EXT	MIN 75%	Y	20%	35%	100%	LISTED
JAPAN	EXT	MIN 75%	Y	RESTRICTED	UNLIMITED	90%	LISTED

The next important feature for this part of the research is to look at the impact that countries adopting a REIT structure have discovered, as well as looking at the key benefits and disadvantages of REITs.

### 2.1.9 The impact of adopting a REIT structure

The opinions of international studies and experts researching and commenting on REITs are considered below.

Jim Rehlaender tells Darby (with reference to determining the impact of REITs) (Darby, 2005) that a REIT structure can bring a highly transparent, well regulated concept into real estate, and can also be an economic benefit for the government as well as for the local population. He further adds that REITs stimulate more capital

flows into the markets where they have been introduced, but the impact on a local economy is hard to determine. REITs can provide more capital resources for real estate, and enlarge access to real estate markets as well as increase the liquidity of the real estate market (Gumbs, 2001). Gumbs thus agrees with Rehlaender that REITs stimulates capital flow into the market.

He also says that determining the economic impact of REIT structures is difficult, but the vehicles are attractive for other reasons. What REITs definitely does is provide another outlet for governments and businesses to sell their real estate, states Gumbs. Richard Adler, a colleague of Jim Rehlaender and also managing director of European Investors, tells NAREIT in the same article by Courtney Darby in 2005, that the benefits from adopting a REIT structure go beyond those for a specific country, and create broader advantages for real estate markets worldwide, because if one country establishes a REIT it then creates pressure on neighboring countries to do so as well.

Although REITs are a sophisticated investment vehicle, they won't drastically change a local economy upon being introduced. 'REITs are merely another form of holding real estate' (Newell & Fife, 1995). However another researcher, Bone-Winkel, differs in opinion, and states that REITs aren't as highly correlated with the major indices as most industries are. As such, they may provide a portfolio with some much-needed diversification and should help to smooth out overall returns, particularly during market downturns (Bone-Winkel, 1994).

Already we see differing opinions with regard to the introduction of REIT structures. One belief is that it simply brings another form of investing, and the other is that stable capital flows arise out adopting a REIT structure increasing the liquidity of the property market.

Other research findings on the impact are listed below.

- When a country adopts a REIT-like structure, history suggests the dividend yield for the asset class increases dramatically as a result of the distribution requirement.
- The adoption of the REIT structure in Japan supports this belief, and corroborates this hypothesis.
- The findings of Waters and Payne support this, concluding that, in order to qualify as a REIT for tax purposes, a company must return at least 90% of earnings to its shareholders in the form of dividends. Because of this, the average REIT boasts higher dividend yields. (George A. Waters, James E. Payne, 2005).

#### **2.1.10 France**

French researchers have found that, since the adoption in 2003 of the French equivalent of REITs, known as the Siics (Sociétés d'Investissements Immobiliers Cotées) real estate stocks in France, which were being traded at a discount to their net assets prior to the introduction of REITs, moved to being traded on a premium basis after REITs introduction. Claims have been made that this was because investors quickly saw the advantages of the new investment structure (Darby, 2005).

#### **2.1.11 Germany**

Although the Germans have not yet fully implemented the REIT structure, it has been postulated that the launch of REITs in Germany will have a particularly dramatic effect on property investment. Germany is Europe's largest property market, but has a

very small quoted sector at present with only five liquid traded real estate companies. At present, 65% of companies own their own property, with Siemens being the second largest property owner after the government (Lerner, 2006). This is set to change significantly, and it is expected that as much as €80bn will be invested in German REITs in the next five years as owner-occupiers take the opportunity to realize their real estate assets by moving their property into a REITs structure. (Lorenz, 2006).

Martin Becker identifies the following reasons why Germany needs to adopt REIT legislation (Lerner, 2006):

- REITs have become the worldwide industry standard for indirect real estate investments.
- Germany has a well-developed private real estate market, but the public real estate market lags far behind in terms of maturity and market volume. This is mainly because, at present, 65% of companies in Germany own their own property, and Siemens is the second largest property owner after the government.
- There has been a flood of capital from foreign opportunity funds into the German real estate market during the last two and a half years. These funds are looking for capital market exit strategies over the next three to five years. The German real estate capital market has to become more competitive in Europe, and because of their competition with other European markets, will need to follow suit with the implantation of REITs.

The German researchers believe that the REIT industry is the norm for indirect real estate, and that it is a method for increasing foreign investment. This is supported by earlier French research, which found that REITs traded at a premium to their Net

Asset Values after previously trading at a discount to their Net Asset Values prior to the adoption. It was also proven through the Japanese example that the dividend yield increases upon the adoption.

These are all significant factors relating to the impacts of REIT adoption.

Further views from experts on the adoption of the U.K. REITs structure are outlined below.

Prior to the implementation of REITs in the U.K. many experts suggested that it would be highly likely that commercial and industrial companies will increasingly look to move their property assets off their balance sheets and into a REIT structure, thereby increasing the number and size of the investable quoted real estate sector (Petersen, 2004). Companies that previously traded at a discount to their peers could be more easily acquired by their better managed and more efficient (Michayluk, Wilson & Zurbruegg, 2006). This is theoretically supposed to lead to the creation of more specialist REITs, each focusing on specific types of real estate or geographical locations. This is already evident in the U.S.A., where various sectors of property investment exist such as Storage, Hospital, Healthcare, Mortgage, Lodging, Resorts, Apartments and so on.

The launch of REITs in the U.K. did not see all property investment funds and companies converting. According to learnmoney.co.uk and Platt (2007), conversion to a REIT structure was seen as a financial calculation. The companies that have converted made a simple choice, based on the fact that their combined conversion charge is a fraction of the capital gains tax liability they incurred prior to the adoption of the REIT structure.

An interesting article published by Dave Butler, Reita programme coordinator, (Mortgage Finance Gazette, April 2007) looked at the impact of the launch of REITs in January 2007. This article focused on two aspects, the first being from the perspective of companies that have converted. According to them nothing other than the more favourable tax status and new dividend policies have changed. Secondly, from the perspective of the investor following the stock market, where it is viewed as having been a bit of a rocky ride. The article is summarized as follows:

- Higher returns seen in commercial properties over the past few years have been largely due to the anticipation of REITs.
- Analysts believe commercial property investment returns will move back to their more normal position as an asset class.
- Nine property companies have converted to REIT status and another six existing quoted commercial property companies have said they will convert over the next few months, taking REITs to 80 per cent of the total market capitalisation of quoted property sector.
- REITs are required to derive the majority of their income through rent paid by tenants. Those that have converted have businesses focusing on owning, managing and renting property. Developers, who make their income from selling property, will not convert to REIT status.
- There is speculation on two new sources of REITs, property owned by business such as pubs and supermarkets, and public sector property, such as hospitals and prisons

Ernst and Young, U.K. in a report in 2007 found the following:



- Special tax considerations are afforded to REITs.
- During pre-REIT adoption, the market generally performs better due to investor anticipation of the structure.

According to REITa and NAREIT, (Anonymous, 2005) the following have been proven in numerous researches and surveys as the key advantages of REITs:

- REITs provide a diversified alternative to direct real estate investment, as well as a liquid alternative.
- REITs generally own multi-property portfolios with a diversified tenant pool. This provide the average individual investor with the opportunity to invest in a relatively diversified pool of real estate assets (rather than individually investing in a specific property) for a modest investment amount.

Below is a brief summary on the positive impact the adoption of a REIT structure has on the listed property sector of that country:

- Increase in dividend yield
- REITs trade at premiums to their Net Asset Values
- Stable cash injections are created boosting the property market
- Foreign investment increases
- Tax advantages due to high dividend percentage issued

After looking at what some of the experts have noted the impact of a REIT structure, the advantages and disadvantages of the REIT structure are summarized below.

## **2.1.12 Advantages and Disadvantages of REITS**

### ***2.1.12.1. Disadvantages***

REITs are not without flaws, and the structure is constantly evolving. Below we see the key disadvantages of REITs that negatively impact the listed property environment, according to NAREIT and REITa studies:

- Because they can only reinvest up to 10% of their annual profits back into their core business lines each year, most (but not all) REITs tend to grow at slower rate than the average stock on Wall Street. Over time, history has shown that the average publicly traded REIT tends to post annual earnings growth several percentage points below that of the S&P 500. However it must be noted that property is seen as a moderate investment, and although it may not achieve the returns that equities do, it is far less volatile.
- Although the business tends to be a fairly stable one, REITs are not without risk. For example, their dividend payments are not guaranteed, and the real estate market is prone to cyclical downturns.

### ***2.1.12.2 Advantages***

A study conducted in the United States of America by Gyourko (1999), shows the key costs and benefits of converting as follows:

- Tax savings undoubtedly are the most discussed feature of the REIT structure. There are however other benefits and costs. The most prominent cost is associated with the need to raise extra external capital because of restrictions on the ability to retain cash and unless a REIT has very low expectations of growth, it has extra capital raising costs beyond those it would incur if organized as a regular corporation. The financially-related costs of raising

capital (e.g., investment banker fees and the like) amounted to 7%, as found in Gyourkos study.

- Another benefit arises from the fact that the shield against the corporate income tax means that REITs don't have to engage in potentially costly tax avoidance strategies to the same extent as regular corporations. Most strategies include hiring lawyers, accountants, etc to increase leverage to an extent that deductible interest payments, and buying more depreciable assets than would otherwise be purchased in order to increase the depreciation tax shield. Economic theory implies that companies would be willing to spend up to a dollar to lower their tax liability by a dollar (in present value terms), but it provides little guidance beyond that.

The REIT structure may seem less valuable to many firms hampered by its restrictions on retaining earnings in depressed equity markets. Gyourkos concluded by saying it is important that management view their choice of structure as a long-term, even permanent, decision. If a REIT were to develop a tax-exempt shareholder base, switching to a regular corporation to retain cash when external financing is temporarily expensive and switching back when raising equity is cheaper will anger these shareholders. Further, although de-REITing now may be inexpensive, switching back or de-REITing later may anger shareholders once a clientele of investors has developed more fully.

In summary, although the advantages and positive impacts of the adoption are evident, listed companies / trusts will think about the conversion decision. In many countries not all listed funds converted to a REIT structure, using a cost-benefit analysis to aid their decision making. An interesting aspect to look at now is what experts and researchers think of conversion, and to what extent it affects investors.

J.D. Sittons, client portfolio manager of REIT strategy for JP Morgan Securities, Inc., tells NAREIT (Darby, 2005) that any country looking to adopt a REIT structure has many hurdles to overcome. According to him one of the greatest obstacles is the conversion tax placed on companies converting to REITs.

Michael Brooks, executive director of the Real Property Association of Canada (RealPac), found that investors in Canada initially were sceptical of real estate securities, particularly REITs (Darby, 2006).

However he agreed that later on, due to the fact that the managers would answer to the investors, this sentiment changed, and REITs became very popular in Canada.

The UK example earlier mentioned that upon their implementation not all the listed property funds converted immediately. However this was mainly due to the conversion tax imposed, and funds used financial calculations to aid their conversion decisions. They see the REIT as providing minimal tax incentives, and different dividend requirements.

A logical conclusion to this research at this stage would be to assume from the papers and opinion articles that should the proposed South African be the same or similar to that of the existing structures, and particularly the countries that have recently adopted the REIT structure, a similar impact should surely exist. Due to the advantages a REIT possesses many of the funds are likely to adopt the structure, although determining the impact is not an exact science. Therefore it seems very evident that literature definitely supports the hypothesis that the proposed implementation of the REIT structure will have an impact on the listed property sector. The literature also

suggests that to determine the exact impact is a difficult one, which can only be done accurately post-implementation.

## **2.2 PART 2**

After establishing the key aspects arising from the comparison of the selected structures examined, the research now identifies how and why these aspects can impact the performance of listed property and more importantly, a REIT. Researchers seem to agree that the Capital Structure and Management are the key issues. These will be discussed below.

### **2.2.1 Impact of Gearing / Capital Structure**

The capital structure of a REIT is one that is quite similar to other investment vehicles. Traditional methods of generating capital are also applied to REITs (Vigario, 2005).

Gearing, also known as leverage, is one of methods of raising capital. Two sources of raising capital generally exist; the one being debt; which comprises of debentures, long term loans, lease, mortgage bonds and preference shares. The other source is equity; which comprises ordinary shares, reserves, retained income and share issue costs (Vigario, 2005).

Gearing / borrowing has a positive effect on property returns. It allows an investor to increase their return on equity - however this does come with higher risks.

Fluctuations in interest rates can severely impact the performance of property and ultimately the REIT. This is supported by the higher-risk higher-return ideology.

Studies don't show any foolproof level to the amount of borrowing or gearing a REIT should implement. Patrick Rowland (1996) did a study between 1984 and 1992, and his conclusions suggest that borrowing at the end of a boom in house prices is not a smart decision, as interest rates remain high for years after housing returns have declined.

Another Australian study performed by Anthony de Francesco, (2007) concluded that geared returns are dependant on the difference between ungeared returns and the cost of debt (the market interest rate). He also suggests that the level of gearing impacts on the geared return. With high levels of gearing the difference between geared and ungeared returns are vastly different either positively or negatively. The gearing-risk profile is also supported in his research, suggesting that higher gearing induces higher risk. However, more significantly, his research found that gearing bears no resemblance to risk-adjusted returns.

Francesco concludes by saying that the relationship between ungeared returns and the cost of debt (interest rates) directly influences the relationship between risk and gearing by increasing risk.

No definite amount of gearing has been found in any literature. Miller Modigliani theory believes that there is no optimal capital structure, because the advantage of debt will be counteracted by an increase in the cost of equity.

Other findings suggest that the main advantage of gearing is in the tax shield provided where interest payments can be written off. Other advantages include the fact that gearing is a lower cost of sourcing funds, and also that the mandatory interest payments will force management to "think about their investments" and lower the risk

of wasting money on poor investments. However the latter belief is contradicted in Boyd (1995), who suggests that when fund managers are compensated through a management fee based on the total asset value, they use gearing to increase the total value of assets, thus increasing their management fee.

There are theories existing on how firms should raise capital, namely the trade off theory and the pecking order theory. These will be briefly discussed below.

Traditional Trade-Off Theory suggests there is an optimal debt ratio that maximises the value of a firm. This is achieved by trading off the costs vs. benefits of borrowing, and thus holds the firm's assets and investment plans constant (Bond and Scott, 2006). Debt is seen as a tax shield which forces managers to make disciplined financial decisions as the risk of bankruptcy increases; which in turn leads to agency costs between owners and managers (Warner 1997, Damodaran 2001 and Graham 2000). The balance between the costs and benefits is known as the trade-off, and in theory ultimately leads to an optimal debt ratio that increases or maximises the firm's value.

Empirically, Gaud et al (2005) say that debt or leverage is based on five factors, namely growth opportunities, size, profitability, tangibles and risk. Arguments have been raised by Bond and Scott (2006) that this notion lends more support to pecking order theory rather than trade-off theory. Many researchers have undertaken studies to identify whether there is indeed a target debt ratio. The most notable outcome is in Flannery and Rangan (2004) who found that most firms don't have target capital structures, and within a space of as little as two years a firm can close the gap between target and actual debt by nearly half. Studies by Rajan and Zingales, 1995; Ghosh,

Nag and Sirmans, 1999; Fama and French, 2002; Frank and Goyal, 2003, conclude there is no optimal debt level and also found that profitability is negatively correlated to leverage.

Pecking Order Theory is motivated by the thought that asymmetric information and signalling problems are associated with external debt because a firm's financing policy follows the hierarchy of internal funding over external, and debt over equity (Bond and Scott, 2006). This model implies that most firms have no target debt ratio. Myers and Majluf (1984) find that firms will resort to debt first if they are in financial deficit, and if needs are greater, they will resort to sources lower and lower down the pecking order.

This theory is that investors suspect managers sell new shares when they are overvalued, and thus the stock prices react negatively to equity issue shares (Myers and Majluf, 1984). The implication is that firms want to avoid selling equity at a discount due to information asymmetry between shareholders and managers. Conversely managers acting in the shareholders' interests issue shares only to resolve debt. This implies that firms with high growth, especially the ones with insufficient free cash flow, have high debt ratios.

Simply put, the pecking order model says that when a firm's internal cash flows are inadequate for its investment and dividend payment needs, the firm issues debt. Equity is never issued, except at high levels of leverage, when the costs of financial distress are significant (Bond and Scott, 2006).



These theories have also been applied to real estate. Allen (1995) found that firms utilize more debt because their assets are sufficient collateral and thus lends support to trade-off theory. Brown and Riddiough (2003), support the theory and also find that firms issue security with a total debt target in mind and firms with secured debt will issue equity.

Howe and Shilling (1990) and Ghosh, Nag and Sirmans (1999) both found a significant negative stock price reaction to equity issues, providing supporting evidence for the information asymmetry (pecking order) explanations.

Feng, Ghosh and Sirmans (2005) also examined US REITs, and found evidence in support of the pecking order theory, summing up that where the costs of adverse selection exceed the costs of financial distress pecking order theory would explain a REITs capital structure.

A useful method in determining an appropriate level of gearing is the weighted average cost of capital formula (WACC). This calculation evaluates the effect of gearing on equity risk and return. The theory in essence weights the cost of the debt as a function of the equity. The WACC formula essentially represents the minimum rate of return at which a company produces value for its investors. If a company's return is less than WACC, the company is shedding value, which indicates that investors should put their money elsewhere.

To conclude the discussion of the theory, it is evident that there is no clear “debt ratio” or ideal amount of “borrowing”. Theories merely suggest the reasons that firms

choose debt as a way to raise capital as opposed to equity. Serious thought and calculations go into the amount of debt or equity that can be handled by a company in order to satisfy parties involved. Therefore it seems evident that any limit to gearing can in fact work, although low gearing limits activity and aggression from REITs from the purchasing point of view. The counter argument suggests that a gearing that is too high forces managers to be 'over aggressive' and 'bulk their portfolio' in order to be remunerated higher. Therefore it would seem that a limit can satisfy both arguments to a certain extent.

### **2.2.2 Management Structure**

Some of the most important choices faced by a firm considering going public concern the structure of the firm's governance and monitoring mechanisms. These decisions influence the initial valuation of the firm, its long-term operating performance, and the investment decisions of institutional investors. (Hartzell, Kallberg & Liu, 2002)

Management is defined as the process of using resources effectively in the attainment of desired objectives. Property ownership's goal, from a listed sectors point of view, is to provide a long term return on the investment in property for investors. Therefore the role of a property manager is to ensure that the value of the investment is maintained in a climate where any appreciation can be quickly battered by increasing costs and economic uncertainty.

The role of the property manager is an extremely important one, and some of the major roles undertaken by a property manager include leasing, tenant administration,

risk management, maintenance, management of expenses and income, budgeting, record keeping and reporting and marketing (Cloete, 1994).

The management structure of any company or fund is vital. In the listed sector confidence in management is sometimes what attracts investors. The management structure of a listed sector company is pivotal in attracting investment, especially from overseas investors. The management of a listed company or fund is essentially broken down into three components: namely the portfolio management, the property management and the fund management. These will be briefly discussed.

#### ***2.2.2.1 Property Management***

Property managers typically are responsible for managing the day-to-day operations at the property level, either full-time on-site at one property, or for a collection of properties within a specified submarket, market or region. Duties usually include leasing and property operations (maintenance, engineering, tenant relationships, on-site construction management, property-level accounting or data entry). Property managers either report to portfolio managers (in vertically integrated companies) or to asset managers (in companies that are not vertically integrated).

#### ***2.2.2.2 Asset Management***

Asset managers and property managers tend to focus more on tactics, i.e. on the implementation of portfolio strategy. Asset managers typically report to portfolio managers, and work through third-party property managers who report to the asset managers. Asset managers, therefore, are focused on managing collections of assets

(as opposed to portfolios) and often are regionally focused. Their primary objective is to coordinate the activities of local property management personnel toward the achievement of the portfolio strategies established by the portfolio managers to whom they report.

#### ***2.2.2.3 Portfolio Management***

A portfolio manager is responsible for a portfolio of assets, and typically operates for the benefit of a third party. Portfolio managers tend to operate at the strategic level, focusing on the development or clarification of portfolio risk and return objectives, on the construction and strategic management of portfolios, and on the monitoring of both market conditions and portfolio performance within the context of overall portfolio objectives.

#### ***2.2.2.4 Effect of management structure on fund performance***

This sub section attempts to answer the following question; “Does structure actually affect performance?”

Based on the functions of managers of REITs / property funds as mentioned above, one would expect management to have a significant impact on fund performance. Such a study has not been performed in South Africa to date.

Agency theory postulates that incorrectly established management incentives can lead to decisions being made that are not in the shareholders best interests. Such decisions

occur mainly when management compensation is not directly related to maximizing shareholder growth (Sagalyn, 1996). He also believes that such a misalignment of incentives mainly occurs with externally management, and this conflict of interests can be eliminated by the use of internal management. Capozza and Seguin (1998) note that the key problem between the two differing forms of management lies not in their formation or structure, but rather the contracts compensating management. Their study tested a hypothesis first established by Jenkin in 1980, which was later empirically proved by Finnerty and Park (1990) which suggests externally managed REITs use greater levels of debt than internally managed REITs. Furthermore their study confirmed that externally managed REITs issued debt with promised rates higher than rates issued by internally managed REITs. In addition, such rates were greater than yields and ultimately affected the cash flows on funded projects. The rationale behind this illogical thinking is the nature of compensation. Capozza and Seguin conclude that externally managed REITs are compensated based on net assets under managed or property level cash flows. Neither account for interest payments. Their study is consistent with Vogt & Cannon (1995) who confirm that externally managed REITs underperformed internally managed REITs. It was also found that, because employees of internally managed REITs don't work for other REITs, they are fully focused on creating value for their shareholders. The fundamental concept behind internal management is that such services can be rendered to private individuals / companies owning property, allowing an alternative form of income for the REIT and finally enhancing the investor's investment.

### **2.3 PART 3**

The key issues as identified when examining international REIT structures are compared to the South African proposal, in order to ascertain which direction it is taking and to examine the likely impact on the property sectors.

The reason that the National Treasury, Association of Property Unit Trusts and Property Loan Stock Association of South Africa are eager for the implementation of REITs is two fold.

The first motivator is that there is a “fragmented regulatory framework” governing the PUT and PLS. This is said to be somewhat restrictive, and ultimately uncompetitive internationally (Treasury Proposal Paper).

The second reason is that the two property vehicles are treated unequally from a Tax perspective (this inconsistency will be discussed further in this chapter).

A further objective is to increase foreign investment in the South African real estate market, which according to the treasury, only sits at around 1% despite being one of the better performers over time.

As illustrated earlier, property experts responding to questions on countries implementing REIT structures say that a REIT-like vehicle is not the answer for all countries, and is not always a solution to poor property performance in such countries. Many are of the belief that it is simply another way to invest in property. However the

last comment is not really applicable to South Africa, as we already have a major listed sector with significant capital raised by listing on the JSE.

The South African Treasury's proposal has indicated that the limit to gearing will be 70%, and this maximum must be incorporated within the Trust deed or Memorandum of Association. This is encouraging from the point of view of the existing listed property investment vehicles, as they will have the same gearing limit. At present a PUT has a gearing limit of only 30% while a PLS has unlimited gearing. The treasury also indicates that only bank sourced debt is allowable. The current level of gearing in the listed sector is believed to be well below the 70% limit. The main objective of the treasury in introducing a gearing limit is to protect investors from capital loss, and it is believed that a higher level of gearing could facilitate higher returns for investors.

**Table 2.2 Gearing limits in REIT countries**

COUNTRY	GEARING LIMIT
US	UNLIMITED
UK	APPROX 65%
CANADA	UNLIMITED
AUSTRALIA	UNLIMITED
HOLLAND	60%
SINGAPORE	35%
JAPAN	UNLIMITED
Proposed SA REIT	70% NAV

This has already been criticized by the American body NAREIT. Their argument suggests there should be no gearing limit, and that the market forces will determine the appropriate level of gearing. However certain analysts and investors believe that REITs should incur a lower level of debt. NAREIT believes this is the sort of force that reduces the level of gearing, preferring “let the market determine the appropriate level of gearing”. NAREIT also proposes that South Africa follow the UK method whereby the interest coverage cannot be lower than 1.25, although this equates to 65%, nullifying their criticism. No limit to gearing would certainly contradict the treasury’s objective of investor protection, and a very low limit will “starve” REITs of funds as they have to mandatory issue 90% of taxable earnings as dividends; leaving them with little retained income to finance new property acquisitions. Lower rates could also force managers to increase the amount of gearing. When interest rates increase this could affect the return in the long term.

The South African proposal requires 90% of annual income be distributed as dividends. As we can see it is consistent with international standards. The 100% requirement in Australia and Netherlands seem quite restrictive; in South Africa the emphasis will be placed on leverage to fund new acquisitions as retained income is nullified. The issue of dividends really affects a REIT in two ways:

- retained income is reduced, leading a REIT to find alternatives for raising capital (debt, etc).
- potential investors will see a steady income stream, knowing that they will receive dividends and more attraction towards REITs as a property investment vehicle will be created.



The issue of dividends is closely related to the capital structure. Therefore, it seems that the South African proposal has allowed REITs flexibility. Pecking order theory can be applied where REITs can select their capital based on the general economic climate of the country.

Below is a comparison of the dividend payout required for the selected countries REIT structure vs. the proposed South African REIT structure.

**Table 2.3 Dividend payout required for the selected countries REIT structure**

COUNTRY	US	UK	CANADA	AUSTRALIA	HOLLAND	SINGAPORE	JAPAN	Proposed SA REIT
PAYOUT	90 %	95 %	85%	100%	100%	100%	90%	90%

### ***Legislation***

As noted earlier, the differing legal forms of a PUT and PLS force them to be controlled by differing bodies. The PUT is effectively a Collective Investment Scheme in Property (CISP). Listed CISPs are conditional upon listing requirements of the JSE and are governed by the Collective Investment Scheme Control Act (CISCA). CISCA is ultimately overseen by a Registrar of Collective Investment Schemes which is Financial Services Board (FSB) function (Treasury document).

A PLS is governed by the Companies Act No 61 of 1973. Listed PLS's are also subject to JSE listing requirements.

Differing management activities and gearing limits are the key differences between the two governing bodies.

The proposal by the treasury aims to form a regulatory framework for the two under the new REIT structure. No legal form has been prescribed, and a REIT can be either a trust or company. The Treasury aims to regulate REITs under the Collective Investment Schemes Control Act (No. 45 of 2002). The treasury document mentions that CISP's or PUT's will be automatically converted to REITs as they are currently housed under CISCA. However it is understood that PLS companies will have to apply for REIT status. Although CISCA doesn't prescribe any legal form, according to the Treasury the governing rules are not able to accommodate non trust entities. The reason for this seems to be in the fact that the deed between the manager and the trustee's become problematic where the manager and the trustee are the same entity. It seems that before implementing REITs to be housed under CISCA, the treasury will have to do some alterations to the act. The treasury does allow management to be internal, and it quite likely that some REITs will encounter the situation where the manager and trustees will be the same entity.

The South African proposal requires that at least 75% of a REITs income must be sourced from rental income from immovable properties. As we can see it is consistent with international standards. This figure seems to work internationally and it makes sense for South Africa not to change this.

## **2.4 Development Restrictions**

Most of the REIT structures around the world allow for development to occur. The exception to the rule is in Singapore, which prohibits development.

The South African proposal permits Development activity, provided it is done with the intent of letting and is retained for at least three years. This is again consistent with international norms.

## **2.5 Taxation of Reits**

As mentioned earlier, driven by the current inconsistent Tax treatment of the PLS and PUT, the need to establish REITs has come about.

We will firstly look at the current Tax treatments of the PLS & PUT individually before discussing the new structure proposed by the treasury.

### **2.5.1 Property Unit Trust**

The Current situation in SA is that no capital gain is realized by the trust upon disposal of immovable property. Capital gains tax is only payable upon a unit holder disposing of his / her unit.

With regard to income tax, a property unit is no different from any other trust, and is taxed at 40%. However as most PUTs issue most of their profits as dividends they are effectively exempt from, or pay very little, tax.

### **2.5.2 Property Loan Stock**

A PLS is treated like any other company and is governed by the Companies Act. Investors in a PLS company receive one part equity component and one part debenture. Interest generated by a PLS in the course of running their business are tax deductible. A PLS like any other company is taxed at 29%.

The main difference between a PLS and PUT lies with CGT. Upon disposal of immovable property, a PLS is subject to capital gains tax of 14.5% on proceeds of the sale. The shareholder, on disposal of shares, is again subject to CGT. This double taxation is what the treasury believes deters foreign investment, hence the need to implement a more uniform and internationally renowned REIT structure.

Another form of tax that is seen internationally is an entry level charge. This prevents exploitation of a REIT for tax saving purposes, and in many countries a minimum holding period is seen. The South African proposal mentions that CISPs converting to REITs will not trigger a taxable event, and no levy will be charged; however PLSs converting to REITs will trigger a taxable event and thus an entry levy will be charged.

### **2.5.3 Management Structure**

The South African proposal currently doesn't legislate which form of property management should exist. It does allow REITs to obtain income from services. Property Unit Trusts might face a problematic situation if internal management is required by law. PUT's have been used to outsourcing the function, and to convert this to in house may cause them to rethink their management strategy. Conversely, many would also argue the need to change what we currently have. Is there a need to do this? Arguments will doubtless be ongoing, with parties both for and against what we currently have.

The American model seems to be a fair one, where REITs choose their management structure based on experiences from earlier external management obligations. With no

enforced method of property management, funds can use trial and error to determine what the best system is, although there is a contrary argument that using trial and error to determine the best method could be detrimental to investors.

REITs are seen as investment type vehicles worldwide and “playing” with such an important aspect would not be in the best interests of the investors, and ultimately would not protect them the way they should be.

Based on conclusions from international studies, it would thus appear that the key difference between the two lies in the method of compensation. If externally managed REITs or funds could be compelled to reassess their method of compensation, this could go some way in narrowing the performance gap between the two.

Currently, in South Africa, property unit trusts at present are governed by the collective schemes act of 2000. The act, with reference to the management of collective investment schemes, states that:

(1) “No person other than a company which has been registered as a manager of a collective investment scheme in property under this Part or its authorised agent may administer a collective investment scheme in property”.

(2) Only a company which:

- is registered as a company under the Companies Act, 1973 (Act No. 61)
- has capital and reserves available as determined in terms of section 88 (1973); and
- employment in its collective investment scheme,

may be or may remain registered as a manager under this Part.

(3) A person who contravenes subsection (1) is guilty of an offence and liable on conviction to a fine or to imprisonment for a period not exceeding five years or to both a fine and such imprisonment.

It can be seen from above that legislation forces external property management on property unit trusts. Property loan stocks on the other hand aren't required by law to have external property management. The debate in South Africa continues whether or not funds should be internally managed or externally managed. Advantages to outsourcing property management include the following:

- Lack of skills – It is often very difficult to create a division in a company when it is not their primary focus. It could prove to be very difficult finding the right skills, and it is possible to lose money initially until the division is fully operational and able to maximise profits for the company. With starting a new division, problems such as how many employees the division should have, and how to pay them, should be considered in respect of the company's broader objectives.
- Professional property management companies will have proven track records, as it is their sole focus to manage properties as opposed to, for example, Progressive Banking, where the sole focus is banking. It enables companies to concentrate on their core business and growth, leaving their subsidiary focus of property management to a capable and competent property management company.
- Better competition – There are a few property management companies around and one can go out to tender to ensure they get the best "value for money".
- An external property company should always provide a better service than in-house property managers, because the external market is competitive, with only a few companies existing. These have to constantly be on their mettle, improving their efficiency to ensure they get continued business. An in-house

property management team could get complacent, as they know they have steady stream of business from the company and may underperform.

- Another difficulty with in-house property management companies is that of comparing them to external property management companies, due to their differences in structure. While property management companies can be compared to benchmark norms, it could prove difficult to gauge in-house property management against these criteria.
- Termination – External property management companies makes for easier termination, as they work on a contract basis. Their services could be terminated with relative ease on contract expiry, and a replacement property management company installed. With an in-house division a company is generally stuck with their employees, as they are subject to stringent labour acts which make it somewhat difficult to terminate employment contracts.

The main advantage of internal management is that the potential for conflict of interests to exist is eliminated. The firm could otherwise engage in a management contract with an external advisor where the employees of the firm own the advisor company. The converse of the previous situation is where the owners and the management are separate entities. Because the external management company doesn't have a vested interest in the company, they may not provide the best service for the fund / company they advise. An important difference between an in-house property management team within the fund versus an externally management company (outsourced function) is the way in which they are remunerated. The in-house division would be treated individually as employees and would receive a salary. The company to which the function is outsourced would receive a management fee. This fee is



normally based on a percentage of total assets they manage (In South Africa this percentage ranges between 0.3 and 0.7%). One can already see the potential for abuse in the latter. Studies have shown that because the advisor receives a percent of total assets managed they tend to “bulk” the portfolio by acquiring more properties and not disposing properties when the more profitable decision is indeed to dispose the property. There have been calls to link the management fee to the performance of the company or fund being managed in order to alleviate the situation described previously.

It is thus clear from the above research that the management does indeed affect performance of REITs, and it has also been proven internationally that internally managed REITs outperform externally managed REITs.

**Table 2.4: A summary of requirements for management structures in REITs**

COUNTRY	US	UK	CANADA	AUSTRALIA	HOLLAND	SINGAPORE	JAPAN	Proposed SA REIT
MANAGEMENT STRUCTURE	EITHER	EITHER	INTERNAL	EXTERNAL OR INTERNALLY (THROUGH A STAPLED TRUST)	INTERNAL	EXTERNAL	EXTERNAL	UNCLEAR / EITHER

**Table 2.5: A summary of the SA Reit proposal**

	MANAGEMENT STRUCTURE	INVESTMENT IN REAL ESTATE	FOREIGN INVESTMENT	DEVELOPMENT	GEARING LIMIT	PAYOUT	TRADING REQ
SA REIT	UNCLEAR / EITHER	MIN 75%	Y	ALLOWED	70% NAV	90%	LISTED

**Table 2.6 A comparison of the SA structure to international REITs**

COUNTRY	MANAGEMENT STRUCTURE	INVESTMENT IN REAL ESTATE	FOREIGN INVESTMENT	DEVELOPMENT	GEARING LIMIT	PAYOUT	TRADING REQ
US	EITHER	MIN 75%	Y	ALLOWED	UNLIMITED	90%	LISTED / UNLISTED
UK	EITHER	MIN 75%	Y	ALLOWED	APPROX 65%	95%	LISTED
CANADA	INTERNAL	MIN 80%	Y	ALLOWED	UNLIMITED	85%	LISTED
AUSTRALIA	EXT OR INT (STAPLED TRUST)	MIN 50%	Y	ALLOWED	UNLIMITED	100%	LISTED / UNLISTED
HOLLAND	INTERNAL	100%	Y	MINIMAL	60%	100%	LISTED / UNLISTED
SINGAPORE	EXT	MIN 75%	Y	20%	35%	100%	LISTED
JAPAN	EXT	MIN 75%	Y	RESTRICTED	UNLIMITED	90%	LISTED

Apart from the gearing limit proposed in the South African REIT structure, our structure looks very similar to other international structures. Of particular importance is that it is very close to the recently adopted UK structure. Hypothetically speaking SA should therefore see a very similar impact to theirs.

On the basis that the South African proposed REIT structure is similar, and the key issues coming out of the literature, the resultant impact of the REIT structure on the South African listed property sector can be anticipated as follows:

- Increase in dividend yield
- REITs trade at premiums to their Net Asset Values
- Stable cash injections are created boosting the property market
- Foreign investment increases

- Sets the standard as far as listed property is concerned
- Tax advantages
- Negative – slow growth due to high percentage of dividends issues (although the tax incentive from this is beneficial to a REIT)
- Another negative impact is that REITs are prone to cyclical downturns

The implementation of REITs is also bound to be a great innovation for the listed property sector in the country. The only issue is the timing, with the possible implementation coming at a time with high interest rates. However, should REITs survive this testing time in the investment market, this will pave the way for future growth and success of REITs.

### **3 RESEARCH METHODOLOGY**

#### **3.1 Objectives**

The objectives of this research are:

- To examine REIT structure and to identify key issues that may affect performance and structure.
- To home in on key issues and to see why / how they can impact a REIT.
- To compare the South African situation to international trends.
- To look critically at the REITs structure.

#### **3.2 Aims**

The aims of this research were

- Firstly, to look at the REIT structures of other countries, and identify the key elements.
- Secondly it was important to look at the impact of REIT implementation in these countries and
- Thirdly, the SA proposal was looked at, compared, and commented on against the existing structures of countries examined in the first part.

The hypothesis was tested on the premise that the similarity of structures facilitates a similar impact in countries adopting the structure.

#### **3.3 Literature influences**

A key finding from the literature was that identifying the impact a REIT structure can have is a difficult one. Researchers agree that it only be done accurately once the structure has been through a quantitative research. A quantitative study involves

gathering hard facts on returns, foreign investment and similar, and proving statistically the impact of the structure. At this stage a quantitative study cannot be achieved for the simple reason that the REIT structure has not yet been implemented in South Africa.

### **3.4 Qualitative versus Quantitative**

A qualitative study was undertaken, as there are no statistics available to conduct a quantitative study.

Qualitative research aims to enquire and examine topics through human interaction. This study is usually performed by interviews, questionnaires or a case study. Opinions from such questionnaires and interviews will either corroborate or contradict the hypothesis. Although quantitative studies are more 'scientific' with the emphasis on facts and numbers, qualitative studies can be more exploratory, and can often provide a broader thought process and greater interaction with respondents. Quantitative research sometimes proves to be very narrow and direct, with the sole aim of testing a finite hypothesis. A qualitative study can thus often prove to be the best option, as it allows the researcher to discover the thought process behind participants decisions, versus qualitative research which allows the numbers to dominate the research findings.

### **3.5 Methodology**

This qualitative research adopted the following methods:

Firstly a draft list of questions was drawn up. These questions were used as a pilot study to determine if the desired objective would be achieved when they were converted to a full questionnaire.

The questions for the pilot study were formed using the key changes (points listed below) in property investment when countries had adopted a REIT type structure. These points were the sole focus of the pilot study.

- Increase in dividend yield
- REITs trade at premiums to their Net Asset Values
- Stable cash injections are created boosting the property market
- Foreign investment increases
- Sets the standard as far as listed property is concerned
- Tax advantages
- Negative – slow growth due to high percentage of dividends issues (although the tax incentive from this is beneficial to a REIT)
- Another negative impact is that REITs are prone to cyclical downturns

After concluding the pilot study, the respondent sample had to be chosen. It was decided that the focus would be on the current listed funds, and more specifically, to send out the questionnaire to all the fund managers of the current listed property funds.

The questionnaires were sent out to Asset / Fund Managers from 21 of South Africa's listed property funds. The questionnaires assisted in answering the research problem and achieve the research objectives. Appendix shows the questions asked to the 21 fund managers. Of the 21 questionnaires sent, 12 responded with a telephonic interview granted by another fund manager, totalling 13 respondents to the 21 questionnaires sent out.

## 4 RESULTS AND FINDINGS

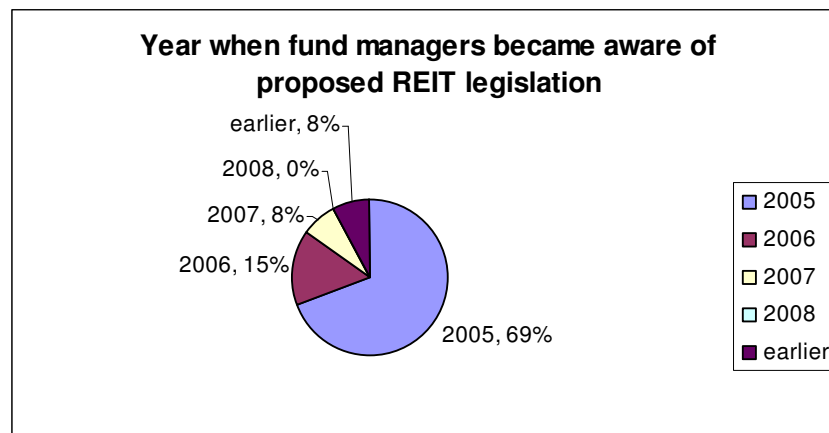
The intention of this research is:

- to determine if the implementation of a REIT structure will have an impact on the listed sector
- to determine, from the international literature, if the industry (listed funds) perception of impact is similar to that of our international counterparts.

### 4.1 Fund Managers' knowledge

The first part of the questionnaire aimed to get a general sense of what the fund managers knew about REIT structures.

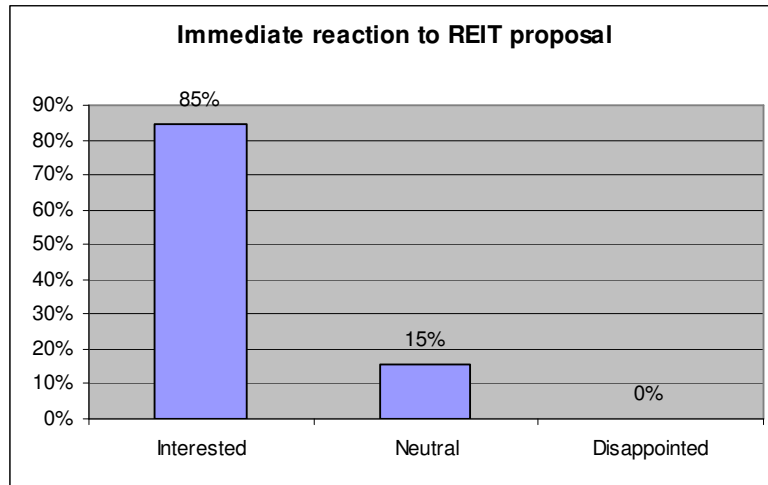
**Fig 4.1 When fund managers became aware of the proposed REIT structure in SA**



From the results it would appear that most managers have been aware of REITS for a number of years, with the peak awareness coming in 2005. This could well reflect the momentum of international trends, with many countries adopting REITS around this time.

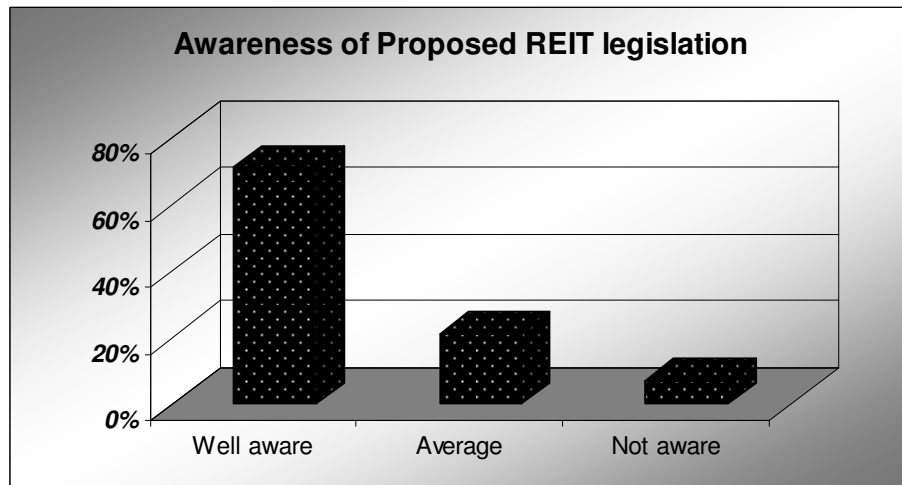


**Fig 4.2 Degree of initial interest to the REIT proposition.**



The REITS concept drew immediate initial interest, which is understandable, coming from experts in the property market. A new and seemingly viable concept (this judgement doubtless based on reports from countries that had adopted this) in property fund management would certainly incite considerable interest.

**Fig 4.3 Fund manager's awareness of proposed REIT legislation**



It is evident from the graph that the persons participating in the questionnaire were knowledgeable about the topic.

One question related to the timing of the REIT to determine if the fund managers thought that the current economic crisis would affect a REIT. All the respondents felt that South Africa is, and has been, ready for REIT type legislation for a long time; and the fact that many countries including South Africa were in a recession did not affect the timing and should not deter the implementation.

In answering the question ‘Why a REIT was required’ the disadvantages, according to the fund managers, were that the South African property market is not conducive for foreign investment, with terminology such as PUT and PLS making it difficult for international investors to understand the local market.

Many felt that liquidity could be improved as well as increasing the market cap (investment). Property Loan Stocks were at a disadvantage from a tax point of view, and very vulnerable to the South African Revenue Service.

When asked to rate the current structure of listed property in South Africa, the consensus among the fund managers is that on a competitive level internationally, a rating of 4 out of a possible 5 would reflect the South African market. However when asked to rate the sector structurally a very negative response was forthcoming, with the majority rating South Africa a 2 out of 5. This indicates that from a structural point of view, there is some room for improvement.

A somewhat critical question was introduced in the questionnaire, suggesting that a REIT was just another form of investment, and questioning whether South Africa really needed it. The response to this question was an emphatic one from fund managers, who all decisively stated that a REIT in South Africa would not be merely another mode of investment, but would instead refine the PUT and PLS models.

As pointed out in the literature, the current proposal by National Treasury does not extend the invitation to convert to a REIT structure to unlisted funds. The question was posed to the respondents whether it should indeed be extended to unlisted funds. The general consensus (87%) felt that it should be extended to unlisted funds, and it would not harm anyone, provided these funds met the criteria to be a REIT.

#### **4.2 To determine if the REIT structure could have an impact on the listed sector**

The next part of the questionnaire focuses on the main theme of this research, to determine if the REIT structure could have an impact on the listed sector, and what the impact of the structure would be on the listed sector in SA.

When asked if they would convert to a REIT, all the fund managers answered in the affirmative. Thus it is evident that the structure will have an impact, as all the listed funds would adopt the structure and the PLS and PUT will fall away.

Many fund managers already indicated that they had started taking action, however no-one elaborated on this issue. In a telephonic interview with a fund manager from the Hyprop fund (Laurence Cohen) it was established that management of the fund was being internalized. Recent reports in the media had also suggested that this was anticipated, and many funds were already looking at internalizing their management.

The next set of questions looked at the structure in detail, with the intention of getting the industry's opinions on what they thought of the proposal, how well this structure could compete internationally, and what impact each aspect of the structure could have on the sector.

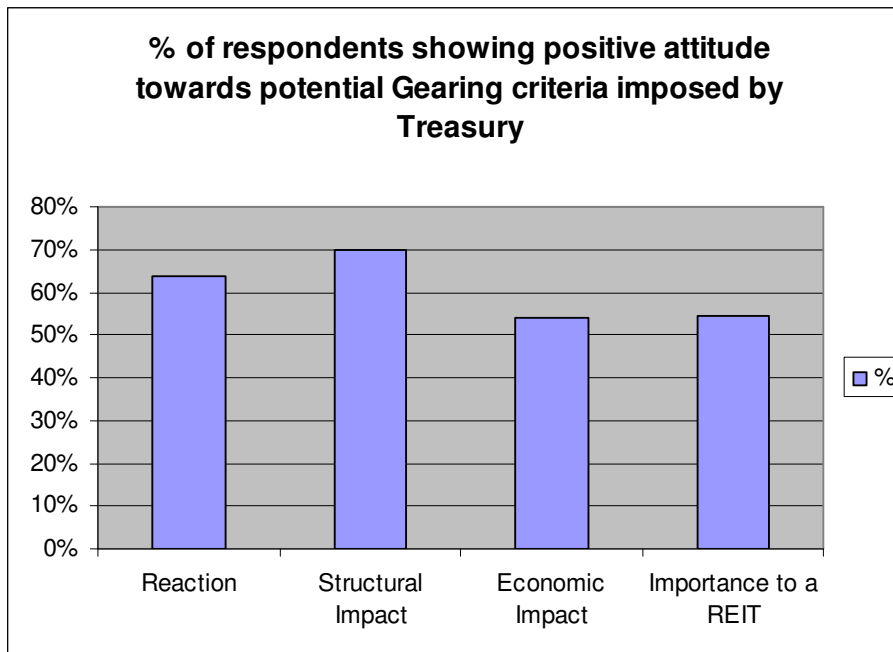
The literature identified Gearing, Dividends, Management, Tax, Development and Investment Restrictions as the as the most likely factors to impact a REIT economically or structurally. Each factor will be discussed individually by firstly summarizing the current literature on each factor, and then looking at what the respondents thought about the impact it would have.

#### **4.3 Gearing**

The literature focused on looking at theories to determine if there was ideal percentage of gearing. No literature was conclusive on this issue, however it was suggested that the limit be carefully implemented, as a limit to gearing can in fact work. It should be mentioned that low gearing limits activity and aggression in REITs from the purchasing point of view; although the counter argument suggests that a gearing that is too high forces managers to be ‘over aggressive’ and ‘bulk their portfolio’ in order to be remunerated higher. Therefore it would seem that a limit to some extent can satisfy both proponents.

The proposal by the treasury aims to limit gearing to 70% of the Net Asset Value of the funds portfolio.

**Fig 4.4 Attitudes towards Gearing criteria**



The above graph indicates the positive thoughts and findings about the gearing criteria in the proposed REIT structure.

63% of all respondents showed a positive reaction to the gearing limit. The questionnaire did not go into details of the reactions by the respondents; therefore it is not possible to ascertain the reason for the negative reactions.

Approximately 70% feel that the structure of the existing funds will be affected by this proposal. This is quite surprising, as a lower impact on the structure was expected because various reports indicated that the gearing limit is currently in the region of between 30 and 35%. With the limit being unaltered, it does seem quite extraordinary that two thirds of respondents expect a significant impact on the structure.

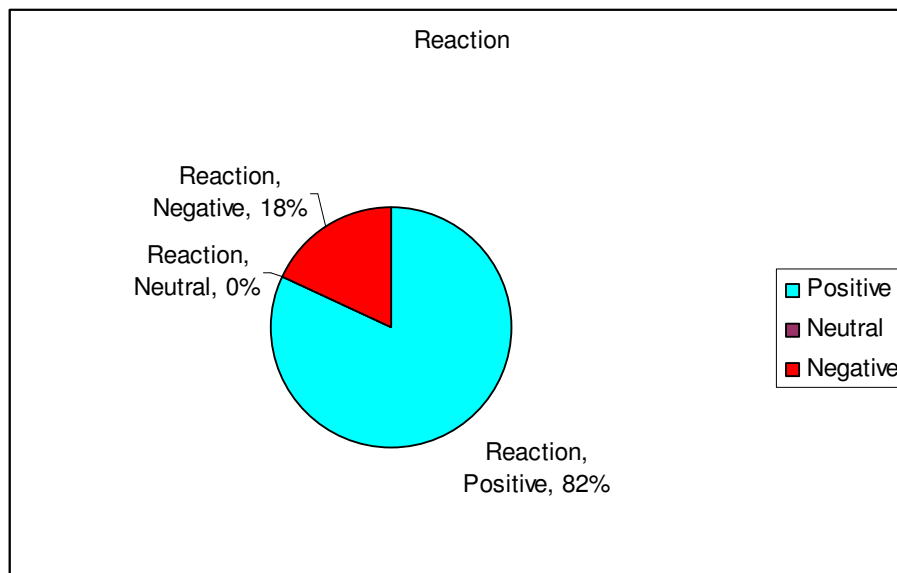
A similar finding to the above exists with the expected economic impact, where nothing has really changed in terms of the criteria. It is surprising then that a large impact is foreseen in the economics of the fund.

The last item on the graph reflects feelings on how important the gearing limit is to a REIT. The industry seems quite divided on this issue. The overall results appear somewhat confusing, especially in that the respondents felt that gearing limits would have an impact on the structure and the economics of the funds.

#### 4.4 Dividends

The next factor relates to Dividends. The current criterion by the Treasury insists that a REIT must issue at least 90% of its income in the form of dividends to shareholders. The literature did establish internationally the figure sits somewhere between 90 and 100%.

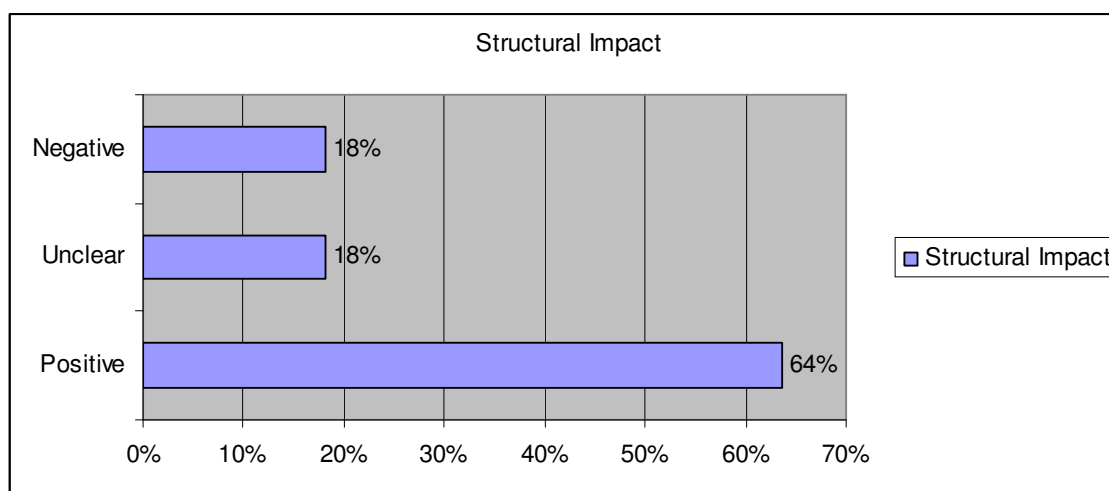
**Fig 4.5 Reaction to dividend criteria**



The graph above shows that the majority of fund managers show a positive reaction to the issue of dividends. As indicated earlier in this report this reaction is expected as it does not deviate too much from the current %.

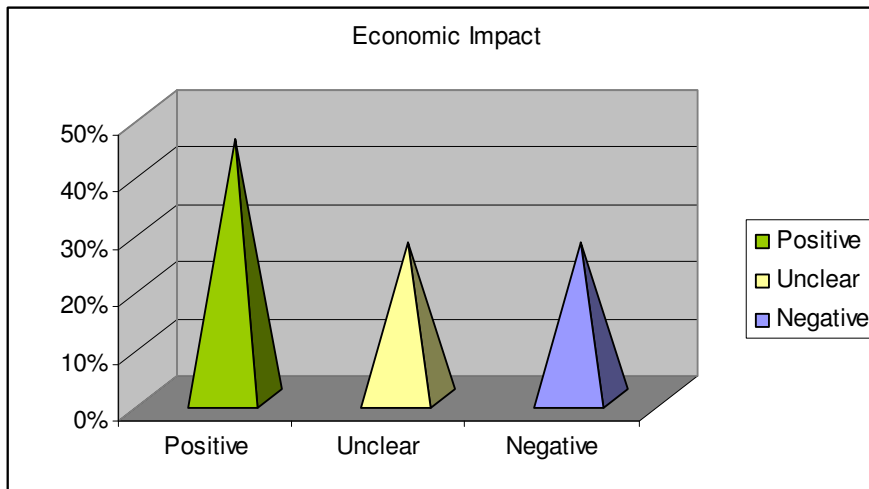
#### 4.5 Structural Impact

**Fig 4.6 Opinions of structural impact on listed funds**



This graph illustrates the general thinking around the potential structural impact on listed funds. Nearly two thirds believe that a large positive impact will be seen on the structure of a fund or REIT. The researcher again queries this conclusion. It has been shown in current reports that PLS's and PUTs both distribute in the region of 95 and 100% of their income in the form of dividends in order to benefit from not paying tax. The findings again don't seem entirely logical as one would not expect such a huge structural impact where nothing in terms of dividend distribution has essentially changed. This result might well be as a result of fund manager's not yet being sufficiently familiar with the nature of the interaction between listed funds and REITs.

**Fig 4.7 Attitudes on economic impact of REITS**



The economic impact of the dividend criteria seems divided. This data seems coherent, as, following from the previous text, things have not changed too much from the existing listed property criterion, and therefore one would not expect too much to change in the future.

55% of respondents feel that dividend restrictions are important to a REIT either in terms of performance or structure of a REIT.

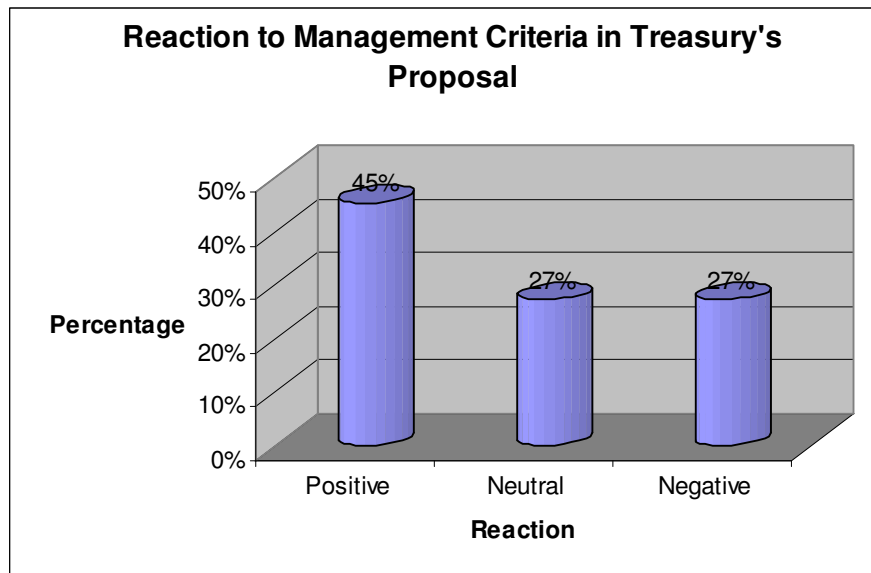
#### **4.6 Management**

The fundamental concept behind internal management is that such services can be rendered to private individuals / companies owning property, allowing an alternative form of income for the REIT, and finally enhancing the investor's investment. International literature clearly suggests that internally managed REITs perform far better than their externally managed counterparts. The South African proposal does not force management to be either external or internal. Bearing in mind the



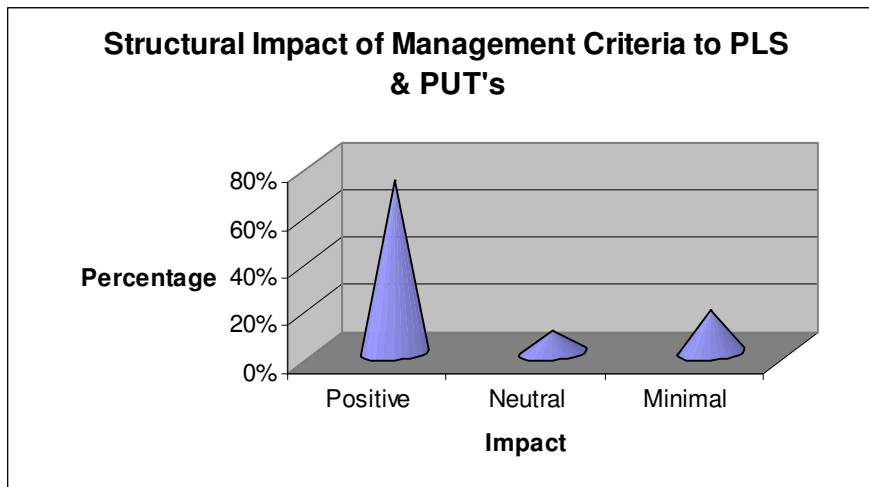
international findings, it was interesting to see what the fund managers thought of this aspect of a REIT.

**Fig 4.8 Reaction to Management Criteria in Treasury proposal**



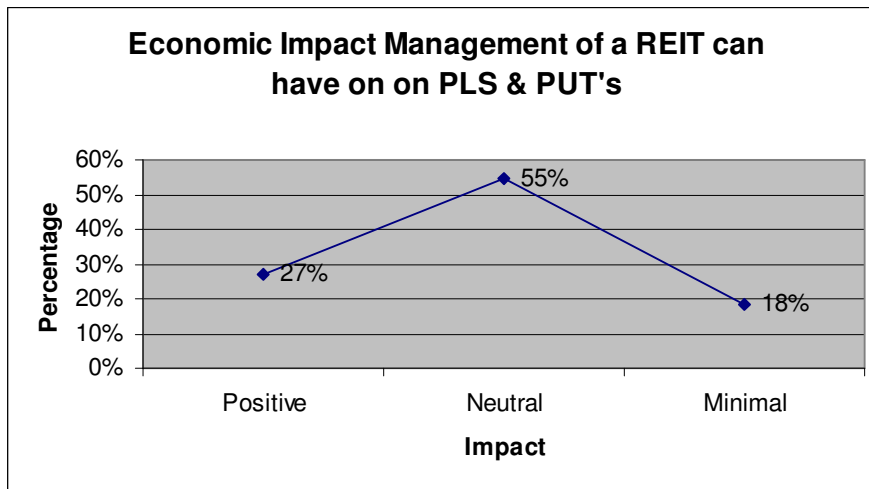
The attached graph shows that only 45% show a positive reaction. It seems likely that these fund managers would have liked the proposal to dictate that management should be internalised. However, in defence of the proposal, it seems the Treasury wishes to allow the market forces to dictate. The favoured case internationally may not always be the preference locally.

**Fig 4.9 Management criteria in PUT's and PLS's**



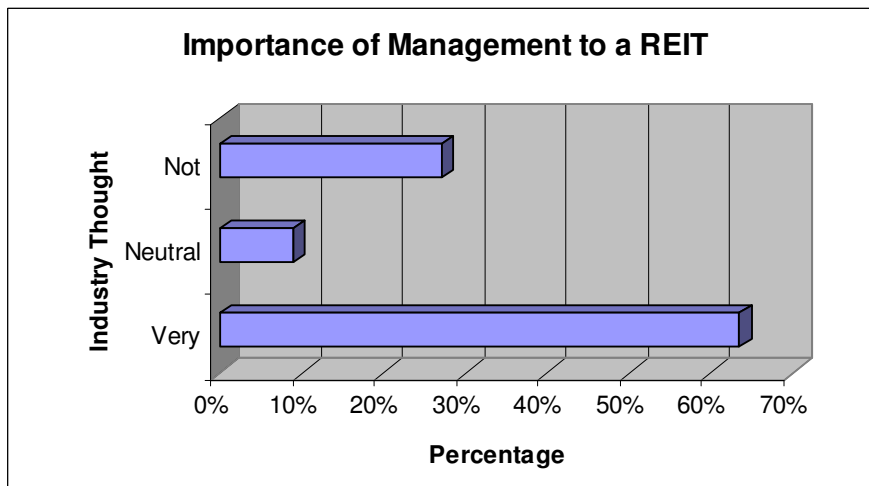
The illustration above is extremely interesting. The fact that in excess of 70% managers think that the structure of a REIT will be affected by this aspect suggests that many believe management will be ultimately internalised. As indicated earlier in this chapter, some reports have shown that certain funds have already internalised management. The respondent in the telephonic interview suggested that their fund would internalise management, and also believed many of their opposition would do the same.

**Fig 4.10 Economic impact of REIT management on PLS and PUT**



The economic sector seems very divided on this aspect. It seems evident that South Africans are yet to be convinced that management can have a significant impact on the economics of a REIT.

**Fig 4.11 Importance of management to a REIT**

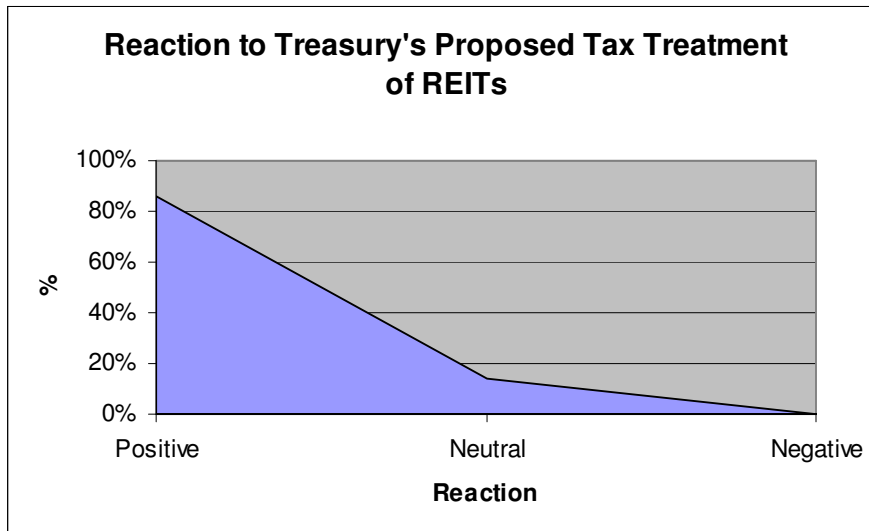


Bearing in mind the previous graph, this attached graph shows conflicting results. It seems likely that respondents believe the management to be important from a structural point of view, yet perhaps not in the economic aspects of a REIT.

#### 4.7 Tax

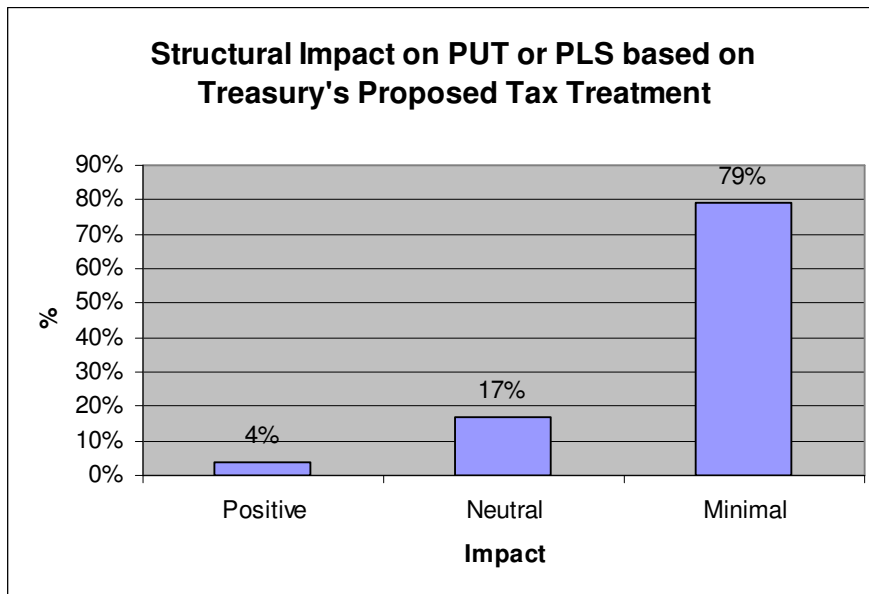
One of the key reasons to convert PUT's and PLS's into a REIT is to create a level playing field from a regulation point of view, particularly in the taxation sense. One fund manager suggested that a major disadvantage of the South African listed sector is the unfair treatment of Property Loan Stocks. Converting to a REIT structure would certainly eliminate this unfair treatment. However it would be interesting if PUT fund managers felt that their 'advantageous' tax treatment should be shared.

**Fig 4.12 Fund managers' reactions to Treasuries proposed Tax treatment of REITs**



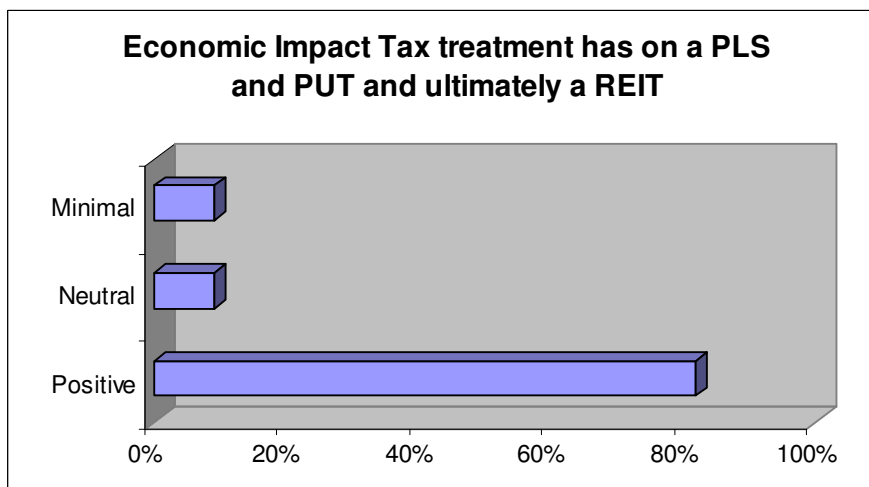
The results show clearly that the majority of fund managers were in favour of the potential REIT tax treatment. It must be pointed out that the 10% that were neutral were indeed fund managers of a Propriety Unit Trust. The lack of a negative reaction suggests that it does not bother PUT fund managers that their PLS counterparts will now receive the same favourable treatment.

**Fig 4.13 Structural Effect of Treasury Tax rules on REITs**



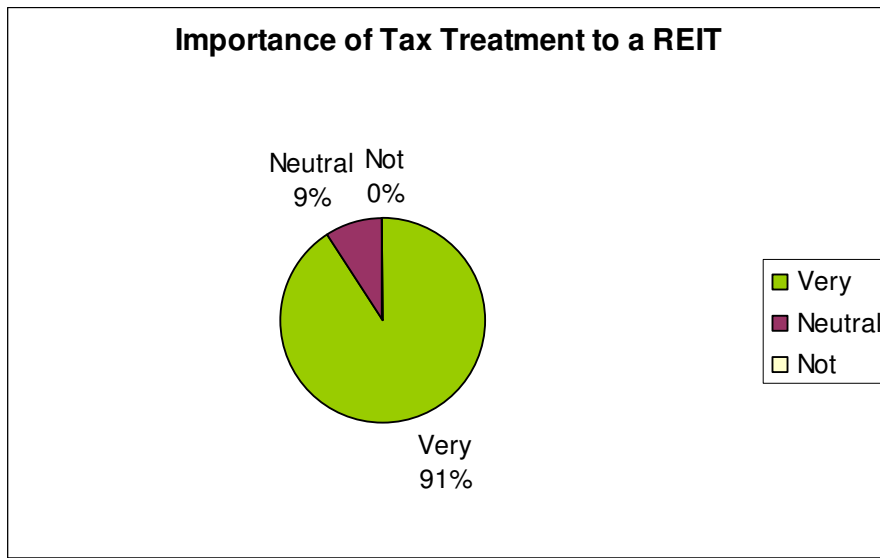
This graph does not show any really unexpected results. It is clearly evident the reasonable tax treatment is unlikely to affect the structure of a REIT.

**Fig 4.14 Economic Effects of Treasury Tax rules on REITs**



The result noticeably shows that the tax treatment of a REIT can have a significant impact on a REIT, especially if the treatment is considered to be a positive one.

**Fig 4.15 importance of Tax Treatment to a REIT**

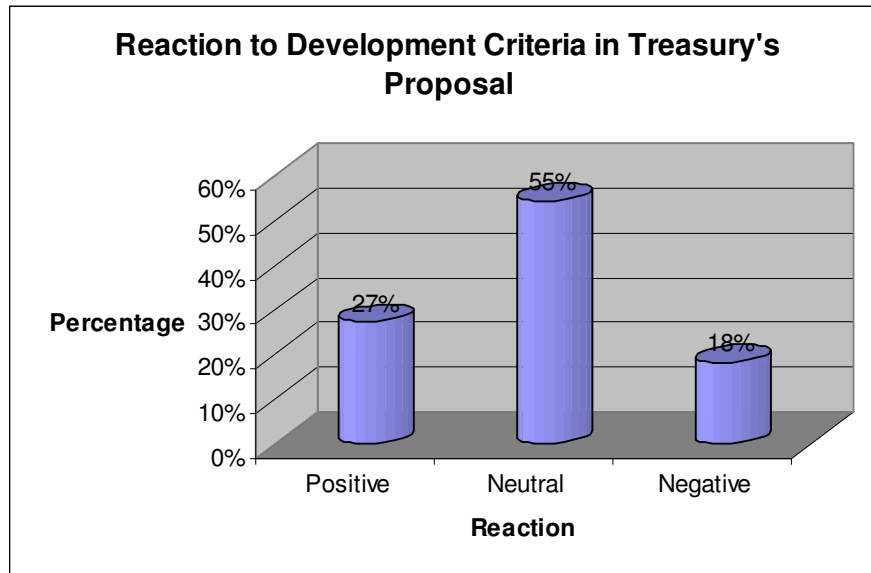


#### **4.8 Development Restriction**

The South African proposal permits development activity, provided it is done with the intent of letting, and retained for at least three years.

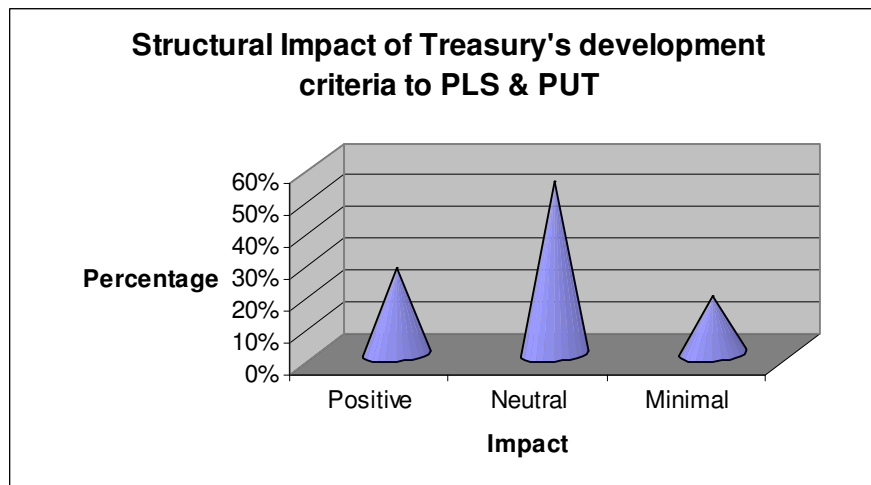
The graphs below show the reaction of fund managers to the aforementioned development criteria.

**Fig 4.16 Reaction to development criteria in Treasury proposal**



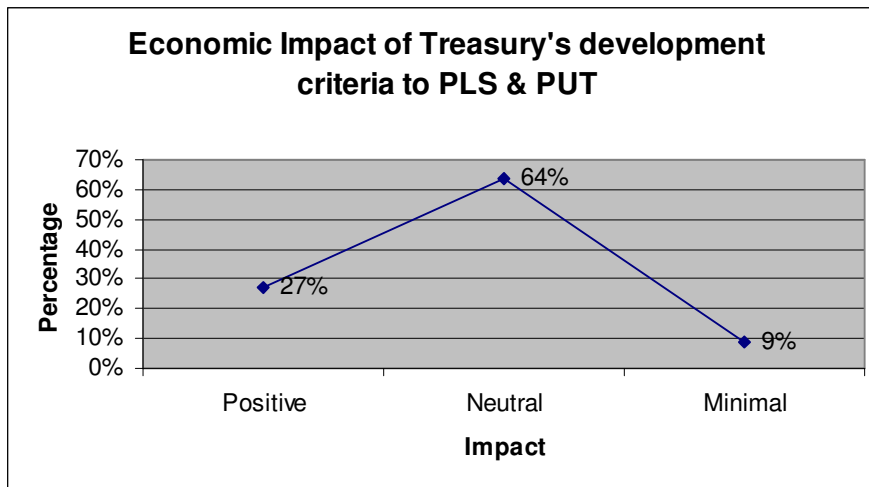
It is evident that the majority of managers show a neutral reaction towards the development criteria.

**Fig 4.17 Structural impact of Treasure development criteria to PUT and PLS**



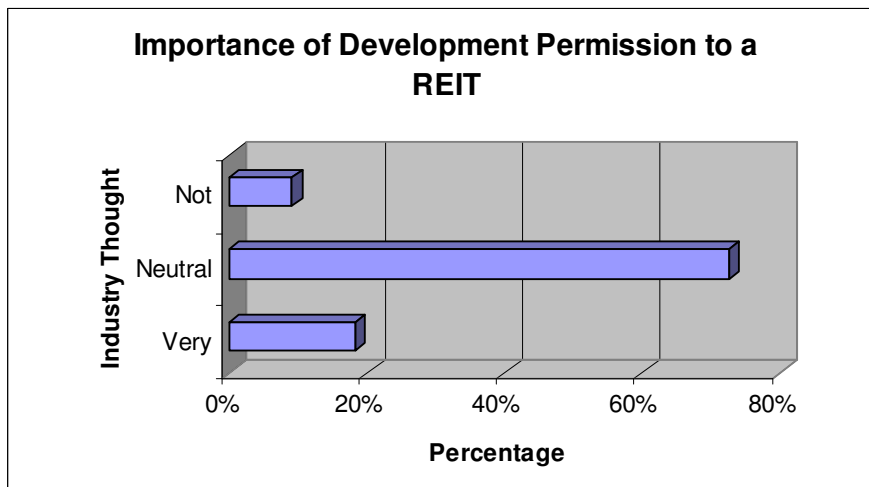
Once again a predominantly neutral reaction indicates that the structural element does not elicit a strong response.

**Fig 4.18 Economic impact of Treasury development criteria to PUT and PLS**



The graph above indicates that in excess of half the respondents show a neutral response to the question of structural impact and economic impact. These results were somewhat expected as the literature did not raise anything of interest relating to development and REITs.

**Fig 4.19 Importance of developmental permission to a REIT**



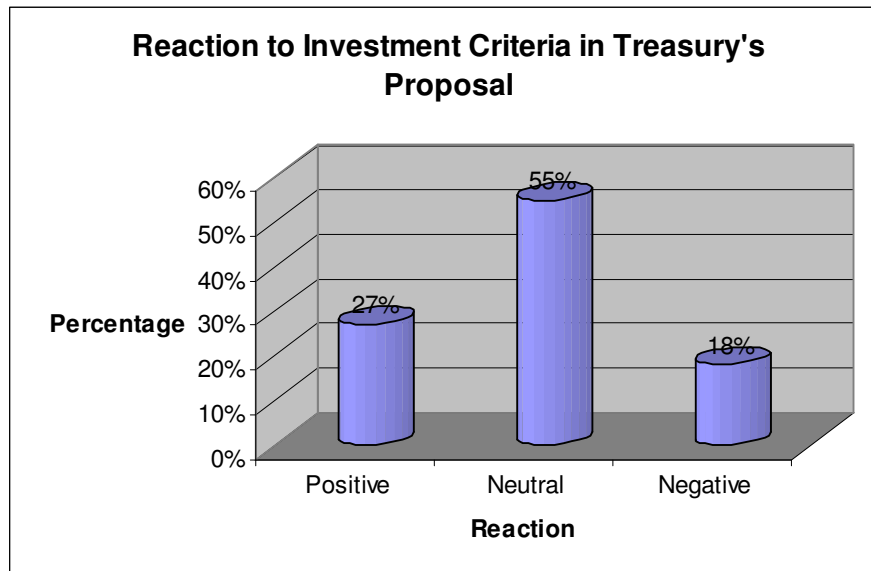
The attached graph highlights the last point and a large majority of the fund managers show the development criteria to be of minimal importance to a REIT.



## 4.9 Investment Restrictions

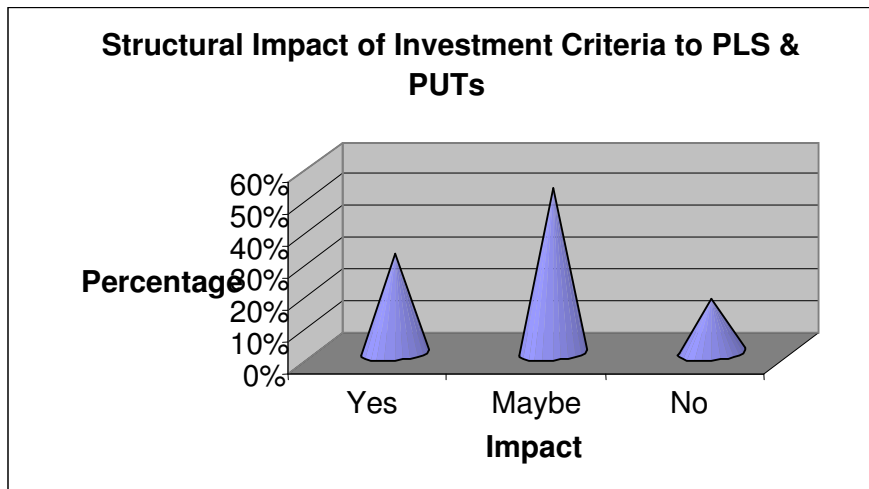
The South African proposal imposes a regulation that states that a minimum of 75% of investment must be in property.

**Fig 4.20 Reaction to Investment restriction criteria**



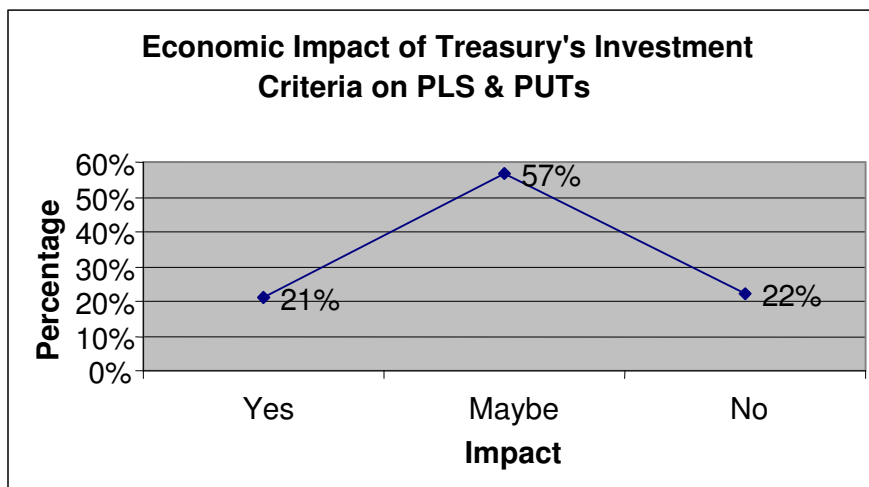
The above graph shows the results of the restriction to be highly concentrated on the neutral reaction. The telephonic interviewee did raise concerns that the treasury does not specify whether a REIT could invest in a REIT which in turn invested in another REIT (two tiers of investment). However, from the criteria one could assume that if the investment figure is less than 25% it should be permitted. It would appear that others did not show too much concern about the same issue.

**Fig 4.21 Structural impact of Investment restriction criteria to PUT's and PLS's**

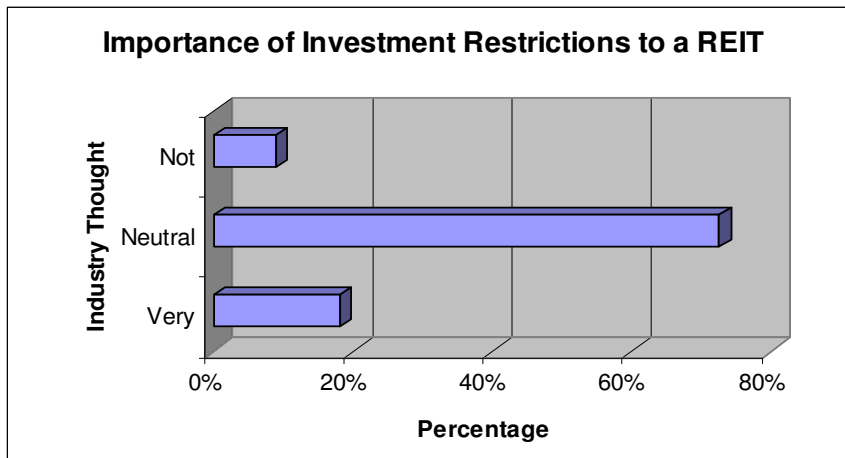


A very similar pattern to the restriction criteria reaction appears when looking at the graph showing the structural impact (above) and the economic impact (below). There is a very neutral, or perhaps uncertain, feeling from the managers relating to the impact of investment restrictions on the sector.

**Fig 4.22 Economic impact of Investment restriction criteria to PUT and PLS**



**Fig 4.23 Importance of Investment restriction to a REIT**



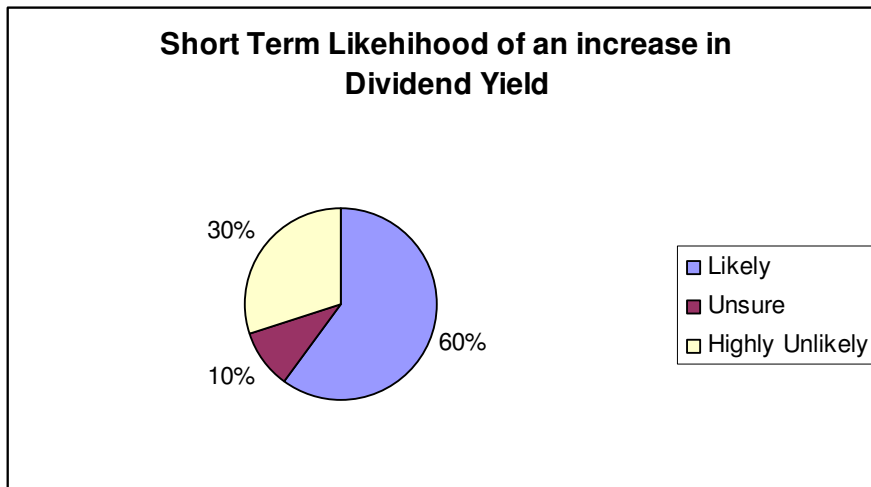
The graph above epitomises the attitude of the fund managers to the investment restriction. It seems clear from these results that the investment restriction is unlikely to impact the listed sector too much.

The literature identified 4 key factors that were affected when the countries selected had adopted REIT structures. These were:

- an increase in dividend yield
- funds trading at a premium to their net asset value
- an increase in property investment (cash injections into the property market) and
- an increase in foreign investment.

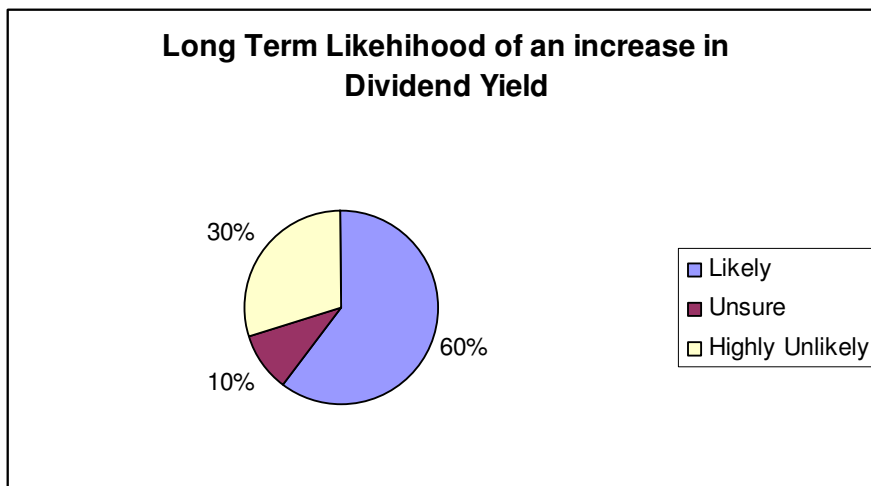
The likeliness of these factors occurring in the SA sector was posed to the respondents. Bearing in mind property cycles and that property is affected in the short and long term; the questionnaire included the short and long term likelihood of such occurrences when SA adopted a REIT structure.

**Fig 4.24 Short term likelihood of an increase in dividend yield**



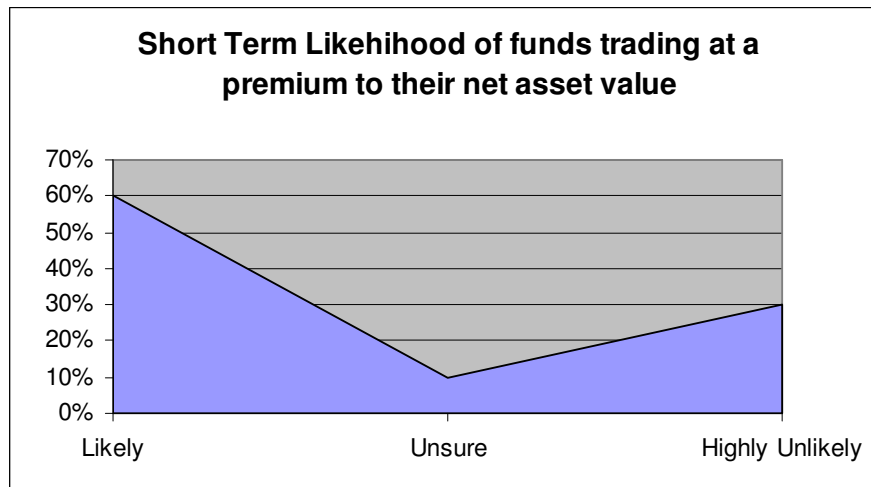
The above graph shows the probability of an increase in the dividend yield in the short term. Nearly two thirds of the fund managers believe this would happen. The next graph shows the difference in opinion over the long term.

**Fig 4.25 Long term likelihood of an increase in dividend yield**



The results are identical to the short run. It seems quite possible that there will be an increase in the dividend yield.

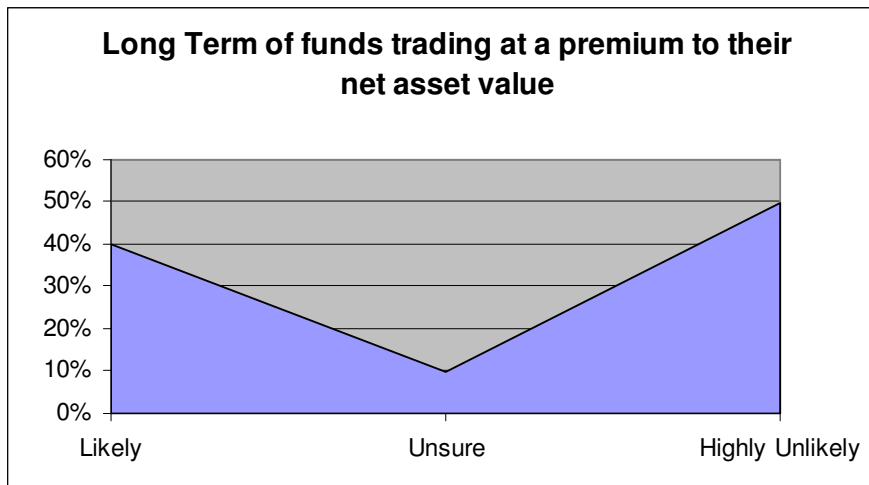
**Fig 4.26 Short term likelihood of funds trading at premium to net asset value**



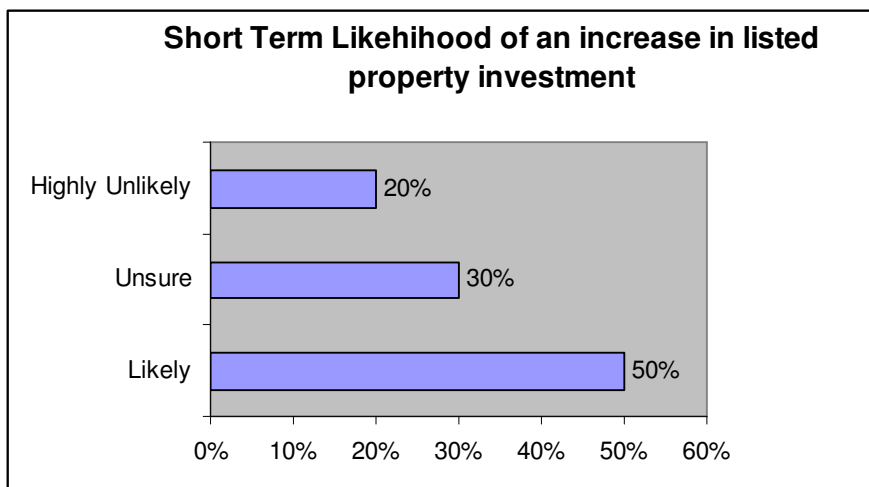
The graphical representation indicates 60% of respondents believe that funds will trade at a premium to their net asset value.

The long term view shown in the graph below indicates that only 40% of fund managers believe that funds will trade at a premium to their net asset value. It seems probable that they expect the new REIT structure to initially be 'flavour of the month', which will settle over time to a more moderate trading pattern.

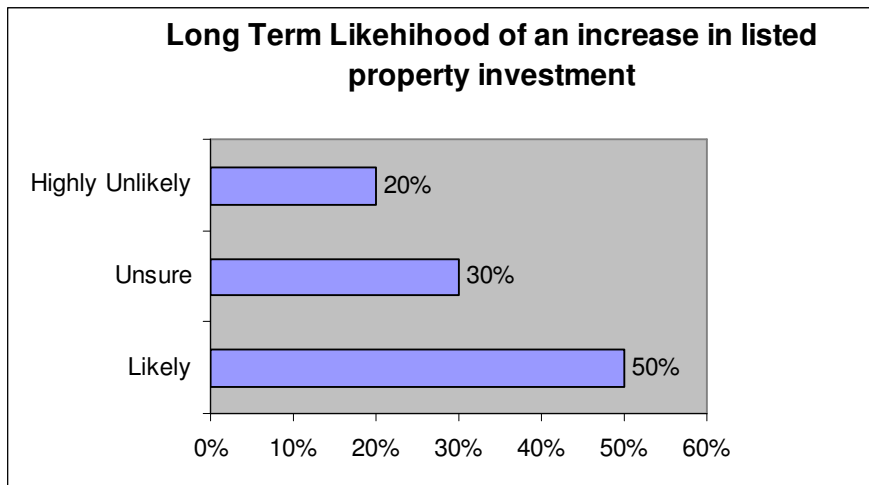
**Fig 4.27 Long term likelihood of funds trading at premium to net asset value**



**Fig 4.28 Short term likelihood of an increase in listed property investment**



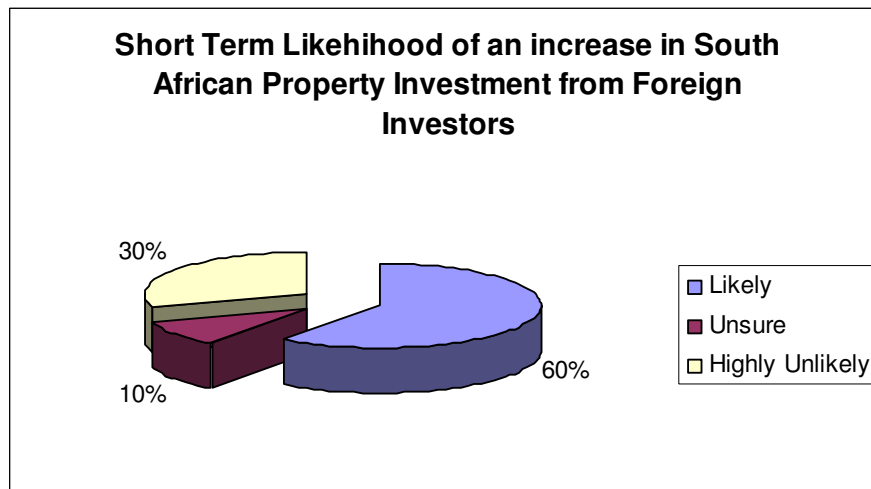
**Fig 4.29 Long term likelihood of an increase in listed property investment**



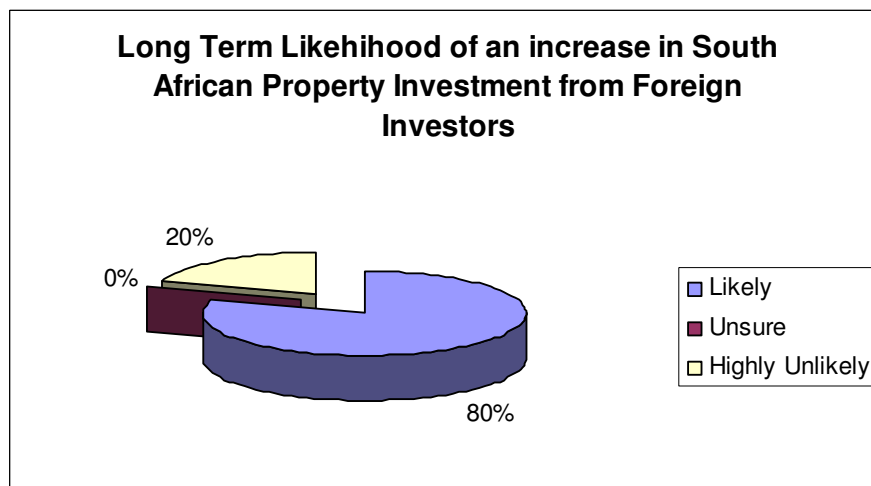
The two graphs mirror each other. It is interesting that the results are somewhat contrary to the literature. The international literature clearly indicated that countries which recently adopted a REIT structure had a boost of cash injections into their listed property market.

The treasury clearly insists that one of their primary objectives for the implementation of a REIT structure is to increase foreign investment. In countries where a REIT structure existed they found that, because of the understanding of a REIT structure internationally, they saw increases in property investment in their country from foreign investors. Thus it was interesting to determine if the fund managers thought that foreign investment into South African property would increase.

**Fig 4.30 Short term likelihood of an increase in SA property investment from foreign investors**



**Fig 4.31 Long term likelihood of an increase in SA property investment from foreign investors**



The results received from the fund managers participating in this questionnaire would certainly please the treasury. They show a 60% likelihood of increase in foreign investment in South African property, with that figure rising to an eighty percent likelihood in the long term.



## 5.1 CONCLUSIONS

One has to bear in mind that this research was qualitative; and, due to the fact that the local REIT structure has not been implemented as yet, the results from this research cannot be conclusive. The results are solely intended to obtain an indication of the possible impact that the forthcoming REIT structure will have on the listed sector.

To summarise the findings: the fund managers did not react emphatically towards particular aspects (Dividends, Gearing, Investment Restrictions, Management and Development Restrictions) relating to the composition of the REIT structure. The only really significant reaction from the fund managers related to the Tax benefits. The fund managers of Property Loan Stocks in particular were pleased that they will be on a level footing with their Property Unit Trust counterparts.

The next two tables summarise the results of this research.

The first table shows the short run likeliness of certain issues being affected when South Africa adopts a REIT structure. These issues echo those considered significant in overseas REITS studies.

At least half the respondents concur that the following can be seen in the short term (first two years after implementation). These positive responses will certainly lend encouragement to, and thus encourage, the implementation of the REIT structure.

**Table 5.1 Short term occurrences in implemented REITS structure in SA**

<b>Short Term Likelihood of the following occurring upon South Africa implementing a REIT structure</b>	
Increase in dividend yield	60%
Funds trading at premium to Net Asset Value	60%
Large cash injections into property market	50%
Increase in foreign investment	60%

The next table considers the same issues as above, in the long term (two to five years after implementation).

**Table 5.2 Long term occurrences in implemented REITS structure in SA**

<b>Long Term Likelihood of the following occurring upon South Africa implementing a REIT structure</b>	
Increase in dividend yield	60%
Funds trading at premium to Net Asset Value	40%
Large cash injections into property market	50%
Increase in foreign investment	80%

The most significant result is with regard to the foreign investment. Eighty percent of respondents believed that foreign investment in the South African listed property sector will increase. Again that result in particular lends much impetus to the likelihood of the implementation.

Literature suggests that implementation of REITs will certainly have a positive effect on listed property, especially with SA looking to adopt a structure that has been tried and tested internationally. An empirical study comparing the current listed sector to the future REIT structure will certainly be a worthwhile exercise after the implementation of REITS.

To conclude: the results show consistency with the hypothesis, that ‘REIT implementation is expected to impact the listed property sector in South Africa.’

## **5.2 RECOMMENDATIONS**

As indicated earlier, this research is largely hypothetical and predictive, and cannot at this stage be confirmed, as the REITS structure has not yet been implemented.

An empirical study comparing the current listed sector to the future REIT structure will almost certainly be a worthwhile venture.

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## APPENDIX

### QUESTIONNAIRE



MSc Property Development and Management, Wits University

Topic:

**A Comparison of selected REIT Structures around the world and the possible Impact the proposed REITS Structure could have on the Listed Property Sector in SA**

Dear Sir/Madam

Thank you for taking your time to partake in this academic research survey for a Masters Degree in Property Development and Management. This dissertation relates to REITs (Real Estate Investment Trusts) and in particular aiming to establish the impact the new structure will have on the listed property sector.

Kindly complete the 10 minute questionnaire and email/fax it at the earliest of your convenience before Tuesday, **14th July 2009**.

Thanking you,

Promesh Ramesh Rampersad

Tel: 083 327 5600

Email: [promeshrampersad@yahoo.com](mailto:promeshrampersad@yahoo.com)

Fax: 086 555 5116

Respondent Name	
Company Name	
Position/Role	
Contact email/tel	

1 When did you first hear of the REIT proposition?

☐ 2005 ☐ 2006 ☐ 2007 ☐ 2008 ☐ Earlier or currently

2 Immediate reaction?

☐ Interested ☐ Neutral ☐ Disapproval/Disappointed

3 What do you think the current advantages of South Africa's listed sector are?

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4 What do you think the current disadvantages of South Africa's listed sector are?

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5 How well aware are you of the proposed new REIT legislation by the treasury?

☐ Well aware ☐ Average ☐ Not aware

6 Is the timing right for a REIT type legislation (bearing in mind recessionary economies in many countries)?

☐ Yes ☐ No

7 Is South Africa ready for a REIT type legislation?

☐ Yes ☐ No

8 Does South Africa need another method of investing?

☐ Yes ☐ No

9 How would you rate the South African listed property sector currently to international property markets on a scale of 1 to 5 (5 being excellent) from a structural and competitive point of view?

9.1 Competitive ☐

9.2 Structural Composition ☐

10 If you are a listed fund, are you likely to adopt a REIT structure?

☐ Yes ☐ No

11 Do you expect more listed funds to do the same?

☐ Yes ☐ No

12 Have you started taking any actions / precautions in anticipation of the proposed structure (if a listed fund)?

☐ Yes ☐ No

13 Do you think that REITs should be extended to include unlisted funds?

☐ Yes ☐ No

14 Should investors be cautious with the inception of REIT's?

☐ Yes ☐ No

15 Will the share price of the fund be affected with the inception of REIT's?

☐ Favourable ☐ Moderate ☐ Adverse

16 Do funds need to be restructured in lieu of the proposed REIT legislation?

☐ Yes ☐ No

17 **Individual Aspects of the Proposed Legislation**

17.1 Please rate the following proposed legislation changes (as per treasury document) between 1 to 5 based on:

(a) your reaction to the proposed legislation (1 being positive)

(b) the expected outcome/impact on both structural and economic factors (1 being significant impact)

(c) the order of importance of these aspects (1 being most important)

	(a) Reaction	(b) Expected outcome on:		(c) Importance
		Structural composition of fund	Economic factors of fund	
Gearing (Proposal to limit gearing to 70% Net Asset Value)				
Dividends (must issue 90% in order to qualify)				
Tax (Eliminates double taxation for Property Loan Stocks)				
Management (No obligation in treasury document, internationally external management performs worse than internally managed REIT)				
Investment Restriction (75% in property)				
Development activity is permitted provided it is done with the intent of letting and is retained for at least three years				

17.2 Are there any factors of importance that have not been covered by the treasury? If yes, please elaborate especially indicating how likely they are to impact funds.

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18 International experience has found the following results upon implementation of REIT type legislation. On a rating of 1 to 5 (1 being most likely) how likely are the following to occur in South Africa:

	Short-term likelihood	Long-term likelihood
Increase in dividend yield		
Funds trading at premium to Net Asset		
Large cash injections into property		
Increase in foreign investment		

19 How would you rate the proposed South African REIT legislation to those existing internationally?

☐ Competitive ☐ Moderately competitive ☐ Uncompetitive

20 As a whole would you expect a REIT type legislation to be advantageous to the South African listed property sector?

☐ Yes ☐ Maybe ☐ No

In your opinion what are the:

20.1 Advantages of REITS

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20.2 Disadvantages of REITS

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Other comments

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